The Canadian Chartered Accountant

Profit Measurement and the Trade Cycle
By K. Lacey

Operating Statements of Life Insurance Companies
By J. R. Neff

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Merry Christmas

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EDITORIAL COMMENT

The Training of the Public Accountant of the Future

SIR Frederick J. Alban, C.B.E., F.S.A.A., President of the Society of Incorporated Accountants, in his paper "Socialisation in Great Britain and its Effect on the Accountancy Profession" delivered to the American Institute of Accountants at its annual meeting last September, has some interesting paragraphs on the subject of training and education. Some of our own members have raised similar points and it may be that further discussion will be reproduced in these columns.

Sir Frederick states: "The days when a man holding a recognized accountancy qualification was spoken of as having 'left the profession' when he took up a salaried post in the organization of an industrial undertaking have gone by. The profession can therefore be regarded as having two aspects:

(a) Accountancy as practised by those who hold themselves out as public accountants (a long-established and well-recognized entity), and

(b) Accountancy as exercised by those who are actually working in industry itself (a more recent conception)."

Later he states: "There is no question but that training in a public accountant's office at its best gives a variety of experience, under conditions of independence in relation to the concern whose accounts are subject to audit, which cannot usually be attained within industrial enterprises. On the other hand, a training in the office of a public accountant is not of itself sufficient to develop the outlook and the techniques which are essential to meet the present demand on accountancy in industry, to say nothing of the increasing demand which is likely to be made in the future."

He then recalls an address of Mr. Basil Smallpiece, A.C.A., (published in *The Accountant,* April 17, 1948) in which the statement was made that in training articled clerks "we are growing neither public accountants as such, nor industrial accountants as such, but accountants capable of being either."

This is a problem with which we are

now faced and which should have our serious attention.

Electric Power

OUR readers have no doubt heard that there are certain shortages of electric power in the Province of Ontario and that power cut-offs are the order of the day and night. Should this and subsequent issues appear later than the usual delivery date, it might be recalled that our printers will be working under some difficulties.

We are pleased to state that these difficulties do not arise from the controversy regarding accelerated depreciation charges to provide for plant replacements. We understand that funds are available to The Hydro-Electric Power Commission of Ontario as and when it requires them. Neither does there seem to be any problem of watered stock or secret reserves or other such objectionable accounting practices. There is, however, an element of poor budgeting in that commitments to customers did not take account of a probable shortage of supply. It is obvious, too, that the inventory position is a healthy one and operated on a LIFO basis with no basic stock to be monkeyed with. With cut-offs from 9-10 a.m. and 4-5 p.m. our office staffs also work on a LIFO basis.

All in all the accounting situation seems satisfactory. But to use a word well-known to hydraulic engineers, the "heads" of the Commission are low and its members are experiencing some trouble in reporting because their current liabilities exceed their current assets. The light that is being thrown on this current situation is well below our minimum standards of disclosure. The outlook in Ontario is dark for the rest of the winter, although in the other provinces it is much brighter. In the meantime, we can assure our friends that we continue to "shine in a pure clear light, like a little candle burning in the night."

Income Tax at the Breakfast Table

(*What happens when an Accountant studies the law*)

A WORTHY gentleman of our acquaintance once made the unguarded statement publicly that one of the tragedies of married life was breakfast. A reporter present passed the remark to the Canadian Press which put it out over its wires to its national and international connections. Soon comments and complaints arrived in volume from all over North America, their burden being that this was a libel, far from the truth and, in any event, most indiscreet. People, just living through breakfast, did not want to be reminded of what they thought was a secret.

Be that as it may, breakfast time is a quiet time and a good time to think over one's activities of the previous evening. But if that evening has been spent in a reading of the law, the following experience may serve to convince that one's usual breakfast habits should be abrogated on this special occasion.

One morning recently, the newspaper being at the other end of the table, our mind turned first to section 129(9 of the new *Income Tax Act*:

> "Where, upon the application of a method adopted by a taxpayer for computing his income from a business or property for a taxation year to which this Act is applicable, an amount received in the year would not be included in computing his income for the year because on the application of that method it would have been included in computing his income for the purposes of this Act or the *Income War Tax Act* for a previous year in respect of which it was receivable, if the amount was not included in computing the income for the previous year, it shall be included in computing the income for the year in which it was received."

Orange juice and a first slice of toast failed to bring forth any real understanding of this sentence and we decided to let it go in favour of thoughts nearer home.

So we turned our mind to the definition of a "self-contained domestic establishment" (ours is surely that) and recalled that, while it used to be that a taxpayer ordinarily had to have his meals prepared and served to him in it, now it was required only that some person had to eat in it. Could it be that there was a taxpayer who refused to eat the meals put before him? Or that a taxpayer who prepared and served meals for himself (because his dependent refused or was unable to do so) was not granted the special exemption? Or could it be that the Department found it difficult to define a meal and encountered cases in which it had to determine that a "hot dog" was not a meal? Perhaps there was no reason for the change other than a desire for brevity.

Then we recalled a sentence in *The Accountant,* October 2, 1948, dealing with the British *Income Tax Act,* 1918: "It is General Rule 16 which imposes income-tax liability on married women and then, by its first proviso, declares that the income of a married woman living with her husband is deemed to be the income of the husband and is not assessable in the wife's name, so that, in the words of Lord Uthwatt, married women who live with their husbands are treated as exceptional persons and relegated to a proviso."

Following this, we wondered whether we could not save a little money by entering into a written separation agreement but to continue to enjoy married bliss as before. We found, however, that the *Income Tax Act* is a great respecter of morals and that we should have to live apart from our spouse to accomplish anything along that line and that, so soon as our agreement was executed, our spouse would not be our spouse and our children not our children. This casts rather a slur on our children so we run to section 25(3) looking for relief; but we find there that children are assumed (unless the contrary is established)to be wholly dependent on their mother. Just how we could establish the contrary we are not quite sure and we seem to have reached a dead end and are very despondent.

At that point a cheery voice says, "Would you like to see the morning paper?" Across the table it comes, open at the social page. The first item we see is that a lady of the Bar in Ontario has delivered a lecture entitled "Married Women, Mental Incompetents and Infants".

We rush our last cup of coffee, now convinced that breakfast really is a tragedy, and we move on to the sanctuary of our office, where two and two always make four and where the time is spent discussing the simple topics of present-day economics, socialism and bureaucracy without regard to any legal complications.

P.S. Lest anyone feel that we should read the newspaper ourselves at the breakfast table, we point out, if this were done, we should have nothing to read in a forty minute streetcar ride to our office. One has to decide for himself at what point to accept hardship.

The New Prince

WE JOIN with all British subjects in an expression of loyalty and congratulation to the Princess Elizabeth and the Duke of Edinburgh on the birth of their son. Although our status has changed, affection and respect for the royal family is not less. We wish them all good health and happiness.

A Christmas Message From the President

IT WAS in some trepidation that your President, at the request of Mr. Taylor, sat down to compose his New Year's message to you. How many times over the past decade have we approached the threshold of the New Year with wistful hopes but wavering faith, only to be once again disillusioned? While our hopes are now becoming dim, we must continue to maintain our faith. This has been somewhat encouraged during the past year by events which have occurred and momentous decisions made in the international sphere, indicating that our statesmen recognize that the realities of the situation must now be faced and dealt with.

We, in Canada, have many things to be thankful for and may enter the New Year with gratitude and hope.

Our profession, in particular, has much to be grateful for, in spite of the difficulties its members have had to meet and overcome during the past few years. Throughout the war and during its aftermath, they have met the demands of government and business and have maintained a standard of service that has enhanced the prestige of the profession immeasurably. Our members and students freely and willingly have made their contribution to the war effort in all its phases with credit and distinction.

Our honoured forebears have established the profession on a sound basis — its roots have been well planted and are now deeply embedded — steady growth has been maintained and it is our privilege, as their successors, to nourish these roots of integrity, independence, sound judgment and competence, so that the growth shall continue and the tree rise straight and true, in sunlight and in shadow, devoted to the service of mankind.

To our new members and students, may I suggest this as a challenge and a trust.

To you all may I extend my heartiest wishes for a Merry Christmas and a Happy New Year.

E. J. HOWSON
President, The Dominion Association of Chartered Accountants.

Operating Statements
Of Life Insurance Companies

By James R. Neff, C.A.

A profit and loss man scrutinizes the Accounting Practices in use

THE PURPOSE of this article is to present a general discussion of the subject of operating statements now published, or otherwise used in the business of life insurance, and to make certain comments which may help to promote a better understanding of such statements. It is my opinion that there may be some aspects of these statements which are causing confusion in the minds of the public which, generally speaking, is more familiar with operating statements in profit and loss form.

Obscurity of Existing Forms

It is not suggested for a moment that there is anything unusual about the figures or the accuracy of the accounts now being produced by the life companies, but it seems that the viewpoint or intention of those who are responsible for the preparation of the form in which the figures are presented may be a little obscure and not readily apparent to the casual reader. Perhaps I am merely exercising that democratic right which we all have of criticising an existing institution with the hope that something may come of it.

The financial world, considered in total, is a very big institution indeed and is governed primarily by operating statements in profit and loss form. On the other hand, the life insurance business has itself become an enormous undertaking. In fact it has become so large that it has developed within itself a type of thinking in regard to financial matters which, to a large extent, is peculiar to itself. It is not at all strange, therefore, that someone may find himself in need of an interpreter to translate a life insurance company's published statement of results into some more familiar financial language.

Two Schools of Thought

In order to understand life insurance operating statements, one must keep firmly in mind what has been mentioned in the preceding paragraph. There are two separate schools of thought in regard to the form in which an operating statement should be presented. The commercial world has its largely understood profit and loss and surplus accounts and the life insurance business presents something else again which, as has been pointed out, is a product peculiar to itself and quite largely misunderstood.

It is my intention to present here a brief description of life insurance operating statements now in use and to interpret them in some simple and approp-

riate manner so that the purpose and intention of each may be understood by all who are accustomed to think in terms of profit and loss. The task of making such an interpretation may indeed be a difficult one. We must realize that the life insurance business has grown to the point where the face amount of its outstanding contracts is now measured at nearly 12 billions of dollars and this amount in Canada is second only to the national debt. Then too, the statement forms now in use appear to have been inherited perhaps from the insurance business of some 60 years ago and since that time have been so severely governed or controlled by the Dominion Insurance Department's annual report that the companies perhaps have not had the freedom one might expect them to have had in the designing of their individual published statements. The form in which the operating statements are to appear is a study of great importance, not only to the life insurance business itself but to its estimated four and one-half million policyholders. In this brief article it will not be possible to present more than a few general comments and explanations in regard to the profit and loss man's viewpoint of such statements.

Cash Statement of Operations

A cash statement, as the name implies, is one commencing with the amount of cash on hand and bank balances as at, say, January 1, and having added the receipts and deducted the disbursements for the year, there are arrived at the corresponding figures of cash on hand and bank balances as at December 31. This form of statement is well known by all of us. It is a very satisfactory instrument for recording and illustrating simple business transactions as every householder knows. But beware! This definitely is not the statement that life insurance companies are accustomed to refer to as their cash statement.

Mr. James R. Neff is a member of the firm of Neff, Robertson and Stone in Toronto. After serving in the artillery of World War I, he entered the office of his father, the late A. C. Neff, F.C.A. and was admitted to membership in the Ontario Institute in 1928. He states that his interest in life insurance companies' accounts is accentuated by the fact that members of the D.A.C.A. are estimated to have life insurance policies totalling approximately 40 million dollars.

In the early days of the life insurance business, a system of accounting studies to interpret results was evolved, which was quite foreign to an ordinary profit and loss account. How such a system originated is now perhaps a matter of conjecture but as good an explanation as any is that it just happened because of one or two peculiarities which arise in life insurance operations which do not normally appear in a set of commercial business accounts.

New Policies

One of these peculiarties is the effect of the receipt by the company of premiums for newly issued policies. At its inception, all of the policy sales of a life insurance company must of necessity be new business as the company is not old enough to have developed an income from renewal premiums. It happens that new business is not profitable for the first few years because the expense of setting up the insurance reserves required, and so placing such contracts on the company's books, is in excess of the early premium income on such policies. The reserve which must be set up as re-

quired by the government to cover the risk, and to ensure safety, must be taken partly out of the company's primary capital contribution. The large initial capital investment required by law of life insurance companies is the necessary buffer to provide for these early losses.

It is apparent from the above that all newly formed life insurance companies must show substantial losses in their operations for several years, or until the more profitable renewal premium income is built up. Eventually profits on renewal premium business more than offset the losses attributable to the writing of new business and it is only when this point has been reached that it can be said that such a company's operating condition is normal.

It is quite understandable, therefore, that when a life insurance company is struggling to get started it does not like to disclose to the public that it is making heavy losses. Such a statement of losses would be bound to make any prospective policyholder hesitate to insure himself in the company. The fact of the matter is that the more aggressive and active the new company has been, the greater will be its losses in these first few years. Perhaps it should be praised for its losses rather than condemned.

Government Concession

It may be presumed, therefore, that many years ago the government recognized the principle that a statement of losses was not a correct measure of such a company's operating result and, to alleviate the situation, granted all life insurance companies the privilege of publishing, instead of a profit and loss statement, a cash statement, so called, which was intended to illustrate not the profit and loss but the amount by which the assets had increased, the amount of service rendered to the policyholders and, in general, the extent to which the company had increased in size and importance in the community.

I have no hesitation in saying that the reasoning or intention behind the publication of this early form of statement was quite sound. It is most unfortunate, however, that a happier or more descriptive title for the statement was not found, as it is perhaps the title of the statement which is misleading. It is not a cash statement but a statement of growth of the assets.

The most disturbing factor about the cash statement, so called, is that most of our life companies are long past their early struggle and have now become mature and financially very sound institutions. The need for them to use the early form of statement has long since disappeared.

Development of New Statement

It is easy to realize that the cash statement, so called, was far from being a perfect measure of a life insurance company's operations and that from time to time some changes were made in the form, in the hope of producing a better measure of the company's growth. What was developed, therefore, was a statement of increases and decreases in the total assets which were caused by the current operations of the business. One can see that such a statement has the appearance of a profit and loss account but, of course, it is not a profit and loss account. It is not intended to be a report of the earnings of the company.

Since the figure used was the total assets and not the net assets, it was expedient to adjust the total having regard for some of the items on the liability side of the balance sheet which have a direct bearing on the assets, such as, for example, bank borrowings to purchase assets.

The ideal form of such a statement of growth would have clearly illustrated, or

shall we say reconciled, the total assets on the balance sheet of one year with the corresponding figure of total assets in the year following. By deducting certain liabilities not clearly disclosed in the statement, the reader finds that the figures presented have no apparent beginning or ending which may be referred to on the balance sheet and, as a consequence, the result shown appears to have no logical explanation. The cash statement in its presently used abbreviated form has, therefore, little to recommend it.

The words "total assets" above have been used for the purpose of description, but the actual total referred to is the total assets less the items of interest and rents due and accrued and premiums overdue or otherwise deferred. Life insurance companies have invented a word for this net figure; they call it — the total of the "ledger assets". Such words are peculiar to life insurance financial studies and are confusing to the general public. From the viewpoint of a commercially trained business man, the interesting figure is the total of all the assets of the company. The total of the book values, or ledger values, without the very good assets of the items due or accrued has no place or significance in the general public's knowledge of finance. In the interest of promoting a better understanding of life insurance statements, it would help a great deal if the use of the term "ledger assets" was discontinued.

Advantage of Cash Statement

There is one big advantage to the life companies in publishing the so called cash statement. Life insurance operating results, more particularly in the smaller companies, are inclined to vary materially from year to year due to several factors. An important one is that the actual mortality rate in proportion to the rate anticipated in calculating the premiums may be high or it may be low and this fact will cause a corresponding fluctuation in the earnings of the company. Then too, as has been pointed out previously, the amount of new business sold may be larger, or it may be smaller, than the average proportion of new business usually sold by the company. These fluctuations are quite normal in the life insurance business and should not be considered as having too great a significance in any one period of operations.

Due to these unavoidable variations in the profit and loss result, however, it is quite easy to imagine the difficulty a company might have in explaining the ups and downs in the results as compared with the figures of preceding years. All must be explained to the policy salesmen and they in turn must explain to prospective purchasers of policies. It is apparent that the difficulty of doing so correctly is nearly an insurmountable one as a full explanation could not be presented with any degree of satisfaction to all concerned.

Disadvantages of Cash Statement

Perhaps with this in mind life companies have continued to use the cash statement form of operating account which has the rather fortunate advantage, from the salesman's point of view, of showing an even or constant trend upwards in the assets and displays the fact that the company has expanded each year which, of course, is the truth. However, it is very apparent that whether or not the company has made a profit or loss during the year has not been disclosed by such a statement. Similarly, since no reference has been made to the setting up of the required annual increase in the insurance reserves, one is unable to discover whether such provision has been duly made in accordance with the usual custom of such companies.

Life Insurance Published Revenue Accounts

Life insurance company executives no doubt are beginning to realize that their cash statements are no longer a satisfactory statement of results, so the present trend of the companies is to change to a form of account which they are quite pleased to call a revenue statement. If the statement was in fact what we profit and loss men know as a revenue statement we would be pleased too. Unfortunately they are not revenue statements but rather an invention of the insurance companies.

Such statements purport to be an appropriate reconciliation of the surplus funds of the company from January 1 to December 31 and may actually appear to reconcile properly. On closer examination, however, we find that along with revenue income and expenditures are included items of other cash receipts and cash disbursements. The reference is to the policy proceeds, dividends and other amounts which have been left on deposit with the company and the withdrawals of such deposits. These items from a financial point of view are exactly the same as the savings deposits and withdrawals of any banking institution. The fact is, of course, that the only parts of the transactions which are truly profit and loss items are the amounts of *interest* paid or credited to the depositors. Such cash entries of principal amounts being included show an unwarranted inflation of both income and expenditures of perhaps some millions of dollars and cause a quite irregular adjustment to be made in the latter part of the statement, such as "Amount required to set up insurance reserves *and to adjust the figure of amounts held on deposit*".

It can be readily seen that this latter phrase, the adjustment of the amounts held on deposit, is just patchwork to cover up the error of including these items in the surplus account study. What is more serious perhaps is that it has prevented anyone from knowing the exact amount required to set up the new figure of insurance reserves. To say the least, it is most confusing to include these items; there appears to be no justification for including them; and the effect, in total, has been to destroy the value of the statement to a considerable degree.

Life Insurance Company Published Surplus Accounts

There are a few insurance companies which should be commended. They have abandoned what might be called the usual custom of the insurance business as a whole and are publishing as an annual report a form of surplus account study which compares quite favorably with the published operating studies of large commercial enterprises.

In my opinion, this new form of statement of surplus is a very long step towards giving the public a truer view and a better understanding of a life insurance company's operating result. A reasonably detailed analysis of the movement in the surpluses from January 1 to December 31 can be very helpful and informative indeed. Then, too, it is a necessary change as it is not likely there are 1000 persons in Canada who thoroughly understand a typical life insurance operating statement. On the other hand, there are perhaps several hundred thousand persons who know, and can read with some degree of understanding, the old familiar profit and loss and surplus account.

The most noticeable and welcome feature in this new form of statement is the complete abandonment of the old idea, in which consideration was given only to a measure of the extent of the

growth in the assets. Growth in the assets does not necessarily have a bearing on the study of results. It would be a strange life insurance company indeed if its assets did not grow substantially each year. But with a surplus account before us, we find whether or not the company has grown soundly and whether or not the company reserves and surpluses have been satisfactorily maintained or increased.

Disclosure of Material Facts

This statement of the surpluses of the business discloses the material facts and does not appear to be subject to as many insurmountable faults as are other forms of statements. It is my opinion that the eventual move throughout the whole of the life insurance business is toward the publishing of this new form of true surplus account. But it will take time and perhaps some better understanding of the problem before the change can be fully accomplished. Perhaps we may hope that the Insurance Department itself will provide the necessary strong leadership required to change the whole system of study of the business of life insurance and put it on a satisfactory profit and loss and surplus account basis. It would not be fair to our Department of Insurance, however, not to mention the fact that the insurance business in the United States is experiencing the same difficulty as we in Canada are in finding an appropriate form for interpreting its operating results. One has only to compare the annual report form used in the United States, the "Convention Blank", with our own Canadian report blank and it is noticeable that the basic viewpoints of each in regard to form are very similar.

Annual Statement Required

This is the printed blank form designed by the Insurance Department and required to be filled in and filed by each life insurance company operating in Canada in accordance with the Canadian and British Assurance Act, 1932. We find the operating result set out primarily in two places.

The first is the Statement of Income and Disbursements (page 296). In general the information required is that of the misnamed cash statement, and both income and disbursements include the peculiar items of the principal amounts left with the company at interest.

The only reason I know for including these cash items in a statement which is nearly, if not quite, a revenue statement may be explained as follows. The insurance business is primarily that of taking the life risk, but, which is not so clearly indicated, there is a corresponding interest risk too. The cash deposits are made with a guaranteed rate of interest payable thereon. It is obvious, therefore, that the difference between the rate of interest earned generally by the company assets and the guaranteed rate to the depositors must be a profit or a loss to be reflected in a true revenue statement. However, both in Canada and the United States it has become the practice, in order to incorporate this study of the guaranteed rate of interest in the statement, to include the principal amounts of deposits and withdrawals. The actual amount of interest paid under such guarantees has been covered up in the withdrawals to the extent that one cannot find it in the statement at all.

The Income and Disbursement Statement does not take into consideration the amount of reserve increases to be set up for the year and, consequently, is a statement which shows an inflated result. The total of the income, less the total of the disbursement column, does not appear to reconcile with any balance sheet surplus figure so that the statement has no apparent worth from a profit and loss man's viewpoint.

Other Statements

Under section 65 of the Canadian and British Insurance Act the officers of the company are required to prepare under oath a statement of the assets and liabilities of the company, and of its income and expenditures. It seems to me that these words quite properly indicate that a full profit and loss or surplus account is called for. However, later in the Act, we find that the form of statement is to be determined by the Minister for the purposes of this Act.

Later on in the report blank we find what is called the "separation of accounts schedule". In the previous record of income and disbursements we find no division of the accounts into participating and non-participating business but in the separation of accounts schedule participating, non-participating and shareholders' accounts are separated.

It is my belief that, in order to present a clear statement of any one fund, the figures positively must not be confused with those of any other fund or liability. The separation of accounts schedule violates this principle in so many respects, that, in my opinion, its value for study purposes by the profit and loss man is very doubtful.

The separation of accounts schedule opens with the balances at credit as of January 1 of a mixture of specific funds, special reserves and the liabilities in regard to cash held on deposit. All of these are dissimilar items. To the opening total is added or deducted items of income and expenditures which are strictly profit and loss matters, items of cash receipts and disbursements in regard to depositors' accounts, items of adjustments of certain liability accounts and, finally, the statement concludes with the same extraordinary mixture of funds, reserves and liabilities as of December 31 (page 298).

It is difficult to explain the separation of accounts schedule. It does not clearly show whether a loss or a profit has been made in either the participating or non-participating sections of the business. It does not show whether any transfers have been made from a fund to a liability, from a liability to a reserve or any of the important movements in the surpluses which have taken place as the result of decisions of the management.

Apparently the separation of accounts schedule is designed for the specific purpose of presenting in parallel form a statement of the movement in the accounts of the participating and the non-participating departments of the business. This makes it possible for the Insurance Department to readily check whether the investment income and profits on asset sales have been properly apportioned to each department. Similarly, the manner in which the expense distribution has been accomplished, and whether it is properly in accordance with the usual custom of the company, may be supervised. It appears that the statement might easily be satisfactory for this purpose.

The Blue Book

From this annual report the figures which later appear in the Blue Book are prepared. The Blue Book is, of course, the annual report of the Superintendent of Insurance to the Minister of Finance in regard to the affairs of all the insurance companies in Canada and is a very laudable effort to record and to build up the vital financial statistics and history of life insurance in Canada.

To change the form of such an enormous mass of detailed information as appears in the annual Blue Book would entail a prodigious effort, but the fact that the form of the accounts seems never to have been changed materially since the inception of the business is unfor-

tunate. Accounting forms which were current and appeared to be satisfactory in the last century are not necessarily in accord with modern accounting principles and practices.

American Convention Blank

A life insurance company operating in the United States must make an annual report to the Insurance Commissioner of the particular State in which the business is being done. Some years ago the Insurance Commissioners of all the States agreed at their annual convention to adopt a standard form of report which would be acceptable to all States. In due course the Blanks Committee of the National Convention of Insurance Commissioners designed the uniform statement known as the "Convention Blank".

The income and disbursement statement in this form contains a great mass of information. It is obviously designed for the purpose of simplifying the work of the State Insurance Departments in checking the detail of the accounts. No effort is made in this statement to divide the accounts between the three groups of partners who own equities in the business, namely, participating policyholders, non-participating policyholders and shareholders, nor does the amount required to set up the increase in the insurance reserves appear.

Later in the same report we have a participating and non-participating gain and loss exhibit, and a shareholders' surplus account study, which do contain, perhaps, the profit and loss information which we are seeking because reserve adjustments are displayed. However, we find included the cash items of receipts and disbursements and so we must consider the results shown with caution.

Similarity to Canadian Report

The similarity of the Canadian and U.S.A. report is apparent. The first statement in each case is the build-up of the approved cash statement. It does not split the accounts between participating and non-participating business nor set up the insurance reserves.

The second statement in each case is the division of the accounts between participating and non-participating business, the provision for reserves is included and the statement becomes in effect a study of the departmentalized position of the business.

While both the Canadian and the American reports no doubt serve the purpose for which they are intended, that of government supervision, nevertheless it is difficult for a profit and loss man to find out from either whether an operating profit or loss was made during the year, and how it was ultimately dealt with in the accounts.

Management Statements for Life Insurance Executives

None of the statements which have already been commented upon appears to me to be satisfactory for the private use of the management of the business. In order to direct the company, a statement is needed which will reflect each pulse in the operations to the extent that any unusual movement in the accounting results will be noticed immediately. It is my considered opinion that the form of operating statement most likely to give this information is a carefully prepared profit and loss and surplus account study.

In order to design an appropriate profit and loss study, one must first consider what operations it is to identify and reflect. In life insurance operations we find there are five main divisions in the accounts which may be briefly described as follows:

1. *The business of owning and operating a large block of assets.* The operating accounts here will present an analytical study of the net income from

assets, revaluation of assets and the profit or loss from sales of assets less the appropriate list of expenses chargeable to this department. Since the funds of the business own the assets mutually, (or shall we say in partnership), then it is necessary to divide the annual net result of asset operations among all the funds entitled to share it. The simple partnership agreement between funds is that each is permitted to share in the distribution in proportion to the mean investment of each fund throughout the year.

2. *The business of selling non-participating insurance policies.* The profits of this section are credited to the non-participating surplus and from there may be transferred at the discretion of the directors to the shareholders' surplus. Such transfers may be made, however, only after completely adequate provision has been made and set up elsewhere to protect the policyholders against all possible loss.

3. *The selling of participating policies, by far the largest objective of the shareholders* These policies are sold and the profit on such contracts is credited directly to the surplus owned by the participating policyholders and is held by the company in trust absolutely for the credit of their account.

One must not expect the shareholders to operate this participating section without payment for services rendered, so we find that the Insurance Act permits the shareholders to take as a management fee up to 10 percent of the participating profits not when earned, but as and when they are distributed. The shareholders seldom exercise their privilege of taking the full amount of ten per cent of the profits but usually take a smaller percentage deemed to be adequate by them.

It is extraordinary that in some life insurance companies the shareholders take to their own credit none of the profits of the participating section of the business and hence receive no fee whatsoever for the important service rendered by them. The explanation is, of course, that this represents full and complete mutualization of the participating section of the business.

4. *The recording of the shareholders' capital and surplus account.* A statement of the movement in this latter account is necessary to a full understanding of what has taken place in the business during the year. However, one must remember that the shareholders are the rightful owners too of the non-participating surplus, subject only to the adequacy of the insurance reserves which have been provided.

If the company has been fully mutualized, then there will be no shareholders' surplus or capital accounts. The participating policyholders would then be the owners of the non-participating surplus and may, at their discretion and, subject to the adequacy of the non-participating reserves, transfer the non-participating surplus to the participating policyholders' surplus. This is the only change in the accounts necessary to complete the process of full mutualization of a life company. The actual difficulty of mutualizing a company, however, is that of distributing to the retiring shareholders their accumulated earnings in the company. Present day rates of income tax on large dividends make the actual process of mutualization impracticable, if not impossible. The solution of the problem of mutualization of such companies may be that of the Government granting special tax legislation which will permit the shareholders to withdraw their accumulated equities in the business on payment of only a nominal tax thereon. (See, for example, the legislation which resulted from the Ives Commission Report in regard to closely held privately

owned companies where surplus earned prior to heavy taxation periods was allowed to be withdrawn on payment of a special tax on the surplus distributed).

5. *The proper analysis and application to the funds of the long list of agency and general overhead expenses.* All of the expenses of the business must be charged to the following operating sections of the business — investment operations, participating operations or non-participating operations. Any expense which can be identified as clearly applicable to one department is charged directly to that department. Next, an appropriate amount of the overhead is charged to the investment department. The remaining balance of the undistributed general overhead must be charged to the participating and non-participating sections of the business and this creates something of a problem but the difficulty has been solved by dividing the total in proportion to the premium income, the number of policies in force or by such other method the management believes to be equitable in the circumstances.

It is admitted that it costs more to handle first year premium business than it does to handle the collection of the renewal premiums. To adjust this, the renewal premiums of the participating and non-participating sections are set down. To each of these figures is added ten times the amount of the first year premiums and the resulting totals become the proportions on which the remaining expenses of the business are divided between these two operating sections. This division seems to be fair enough for all practical purposes. The proportion of ten to one may be varied by some companies to suit more accurately their individual requirements.

Questions To Be Answered

From the foregoing, one can readily see that the questions which must be answered by our profit and loss account are: In what department were the profits made in the business and were the profits correctly credited in each case to the rightful owner? If a distribution of profits has occurred, or if, as a result of management decisions, any other deduction from, or movement in, a surplus account has occurred, then has this fact been clearly shown?

You may keep in mind that a life insurance company operates, from an accountant's point of view, as a partnership and follows all the customary provisions of partnership accounting in regard to the distribution between funds. The company, when it has shareholders, is not a partnership however. It is simply an ordinary limited company which operates a non-participating insurance fund for its shareholders' gain and, in addition, operates a participating insurance fund in trust for the policyholders of that section. Basically, the structure of the company's operating plan is very simple and easily understood if one has some knowledge of how the reserves are set up.

Life Insurance Technical Reserves

I make no pretense at being an expert in the calculation of the highly technical insurance reserve of a life insurance company. It is a matter which is very ably dealt with by actuaries. But some rough discussion of the subject may prove helpful here, as this reserve is of the greatest importance in the study of an insurance company's financial position.

An insurance company's business in force is the face amount of its outstanding contracts. The individual policies, of course, are not payable as of to-day but at some future date dependent on the death of the assured, or the completion of a fixed term contract. By tables of life expectancy calculated from the previous experience of all companies, and

duly set forth in recognized actuarial tables, the actuarial department is able to determine the life expectancy of the policyholder. We have, therefore, an estimated date in the future when the policies in force are likely to become claims, and an indication too as to what proporton of the insurance in force is likely to become a true liability which must be paid. For balance sheet purposes at each year end the present value of this liability must be calculated at some suitable interest rate based on an estimate of what the assets of the company are likely to earn over the period.

In the interim between the balance sheet date and the date when the claim is expected to be paid, the company has, of course, the very valuable asset of the annual premiums to be received from the policyholders. The amount of the asset of the annual premiums to be received must be reduced by calculations to terms of present day values at the date of the balance sheet.

Two Vital Risks

From this it is clear that the reserve is intended to cover two vital risks. One is the death risk, the other is the interest risk. We have the present value of the liability in regard to outstanding policies, and from this it is logical to deduct the asset in the present value of the annual premiums to be collected. It is the net figure of these two amounts which is the reserve for balance sheet purposes.

As has been said, the above discussion is intended only as a rough explanation, and it is not necessarily correct from the actuarial viewpoint. We can note here, however, one major difference between individual companies that has some bearing on our profit and loss viewpoint. One company may set up its reserve on a "net level basis", which means that the full amount of the necessary reserve is set up for each new policy when the first premium is received. Another company may set up its reserve on a "modified basis", which means that the initial cost, or rather the normal loss in setting up a new policy reserve as explained previously in this article, is spread over a longer period. Either of the two plans appear to be sound.

But let us again revert to the profit and loss man's viewpoint. Let us say that in a commercial concern the profit or loss is determined by the annual taking and calculating of an inventory of a merchandise asset. In life insurance an annual inventory and calculation is made of a reserve liability. The processes are essentially similar.

Termination of Policies

The settlement of claims is another subject that warrants a brief description here. Eventually a policyholder dies, or an endowment matures, and the payment of a claim becomes necessary. It is the several ways in which the claim may be settled with the beneficiary which interests us. He may be given cash for the full amount due. He may leave the money on deposit with the company at a guaranteed rate of interest. He may be given a fixed monthly income either for life or guaranteed for a certain term. Or the settlement may be any combination of the above, provided that it be in accordance with the terms of the original contract with the insured person and, subsequently, with the wishes of the beneficiary.

The Profit and Loss And Surplus Accounts

As an illustration (see Appendix 3), a form of management profit and loss study is reproduced on page 301 which it is believed will give the required information about the operations but with the briefest possible detail. No figures are inserted as it is not proposed here to discuss results. If results were to be

discussed, then the figures would have to be reduced to percentages of either the opening balance in each department, or some other appropriate total, and then compared with corresponding percentages for the past several years. This is necessary as in a rapidly expanding business, such as life insurance, figures to a large extent lose significance and a study of ratio and proportion is the vital matter for consideration.

All of us are aware that accounting is a very wonderful instrument for the purpose of keeping records and for the measurement of certain aspects of a going business. It is a product of hundreds of years of thought and no one can deny that it has played a great part in the building up of the financial structure of the world. But we accountants recognize that in spite of the very practical efficiency of the profit and loss account it has, nevertheless, certain faults and weaknesses which cannot be readily overcome. In our life insurance operating statement, therefore, we must discover the important faults and take such measures as are available to us to correct them as follows:

(a) The profits will vary in proportion to the mortality for the year. This fault may be partially overcome by inserting as a memorandum on the profit and loss account a record of the mortality rate for the current period as compared with a similar rate for the past few years.

(b) The profits will vary in proportion to the new business which has been placed on the books during the year. This fault may be provided against by showing the amount of new business premiums and commissions separate from the renewal premiums and commissions and then, as a note, the average amount of the new business premiums received during the past few years should be inserted.

(c) Life insurance executives like their company statements to show the extent of the service that has been rendered to the policyholders. This can be illustrated to some degree by showing separately the amount of the policies terminated normally by maturity or death. Policies terminated by the payment of cash surrender values represent those uncompleted contracts which have been abandoned by the policyholders, or fixed term policies which were originally taken out for some special purpose and have then been cancelled.

(d) In the participating section there is one big fault in the operating statement which is most difficult to eliminate. When a participating policy is sold, the premium charged will be higher than the corresponding premium in the non-participating section. This increased premium together with profits provide a dividend which may be returned to the insured at a later date. This extra amount of premium is the well advertised savings feature in this type of policy contract.

The dividends are chiefly of two kinds, annual or quinquennial. Since the participating premiums have been increased to provide for savings then the profits of this section should be considerably higher in proportion than the profits of the non-participating section. So, as a matter of convenience, the attached form of statement shows the annual and quinquennial dividends displayed as a withdrawal from the participating surplus. It is obvious that this is not quite correct and that care should be taken in this regard in reading the amount of the profits for the year in the participating section of the business.

e) On occasion a certain company might be going through the process of gradually increasing over a period of years the severity of its basis of reserve calculations. It would perhaps be chang-

ing from a $3\frac{1}{2}\%$ to a more conservative 3% basis. If such is the fault in the statement, then, in order to read the result of the operations, one must know the increased amount of reserve which has been added in any one year over and above the basis used in the previous year.

Conclusion

To conclude this report I again call attention to the fact that this has been a very short article on a very long subject, and that it is quite possible that some of the comments made, while indicative of a point of view, may, nevertheless, be altogether too brief to be fair to all who are concerned in the preparation of life insurance operating statements. On the other hand, I believe that the following few recommendations do fairly set out the viewpoint of the profit and loss man in regard to operating statements now in use by the life insurance business:

1. That the life insurance business should clear itself of the use of financial terminology which is not now currently familiar to the general public. The specific reference here is to words such as "ledger assets", "cash statements" and all such similar words as are foreign to persons accustomed to profit and loss account studies.

2. That the statements in whatever form they are presented should be clearly titled. The cash statement of life companies is not a cash statement. Call it, if you will, a "statement of growth", and disclose how it reconciles with the figures of the total assets on the balance sheet from one year to another. The best plan would be for the Government to permit this form of statement only for the first ten years of a life company's existence. Thereafter it should be required to publish a proper statement of surpluses.

3. That mature life insurance companies should be required to publish surplus accounts which reflect the movement throughout the year in surplus balances which may be identified on the published balance sheet in each year. Each company should have complete freedom to design the details of its own statement, but cash receipts and disbursements should not be included, and, definitely, the opening and closing balances should appear prominently so that over a period of years the statements will show a proper continuity.

4. That the executives of such companies should adopt for the purposes of management a simple profit and loss and surplus account study with appropriate schedules attached to give further detail of the larger figures. Such a statement would be welcomed by commercially trained newly appointed directors of insurance companies.

5. That the life insurance business should recognize even more clearly in its operating statements the division of the accounts between participating and non-participating operations. Unfortunate- these two departments of the business have the appearance of being similar funds but as a matter of fact they are not. The participating section is a trust fund and the non-participating section is a shareholders' operation. Attention is called to one of the most profound rules of the basic theory of fund accounting — for the purpose of presenting a financial statement the accounts or records of dissimilar funds may not be combined.

Appendix 1

Fig. 1

DOMINION OF CANADA

INSURANCE DEPARTMENT

Form of statement required to be filed by companies operating in Canada

(*Note: This statement has been considerably condensed for the purpose of this article. It contains the information which the companies publish as their cash statements. See how the totals are carried to the* RECONCILIATION OF LEDGER ASSETS *below. We can now describe the cash statement exactly as — an incomplete reconciliation of the figures of net ledger assets.*)

STATEMENT OF INCOME AND DISBURSEMENTS

Income

Premiums (various)		$ 000,000
Amounts left with the Company at interest including dividends, amounts insured and amounts received for the payment of future premiums		00,000
Interest, Dividends and Rents on Investments		00,000
Income from other sources		0,000
Gross Profit on sale or maturity of ledger assets, i.e. real estate, bonds, stocks etc.,		00,000
Total Income		000,000

Disbursements

Claims, matured endowments, etc.		000,000
Dividends to Policyholders		
Paid in cash	00,000	
Left with the company at interest	00,000	
Applied as single premiums	00,000	00,000
Payments on Annuity Contracts, etc.		000,000
Amounts left with the Company at interest and interest accumulations withdrawn		00,000
Dividends to Shareholders		00,000
Taxes, Expenses, Salaries, etc.		000,000
Gross Loss on sale or maturity of ledger assets, i.e. real estate, bonds, stocks etc.		00,000
Total Disbursements		000,000

Appendix 1

Fig. 2

DOMINION OF CANADA

INSURANCE DEPARTMENT

Form of statement to be filed by companies operating in Canada

SYNOPSIS OF LEDGER ACCOUNTS

Net Ledger Assets, January 1	$000,000	
Borrowed Money	00,000	
Bank Overdraft	00,000	000,000
Add:		
Increases in Ledger Assets during year		
Income (see details above)	$000,000	
Increases in borrowed money	00,000	
Increases in bank overdraft	00,000	000,000
		000,000
Deduct:		
Decrease in Ledger Assets during year		
Disbursements (see details above)	$000,000	
Amount by which ledger assets were written down	00,000	
Decrease in borrowed money	00,000	
Decrease in bank overdraft	00,000	000,000
Net Ledger Assets, December 31	$000,000	
Borrowed Money	00,000	
Bank Overdraft	00,000	000,000

Appendix 2

DOMINION OF CANADA

INSURANCE DEPARTMENT

Form of statement required to be filed by companies operating in Canada

(Note: This statement has been considerably condensed for the purpose of this article. It is the source of the figures used in the so-called published Revenue Accounts. However, Revenue Accounts usually show participating and non-participating amounts added together.)

SEPARATION OF ACCOUNTS SCHEDULE

	Participating	*Non-Participating*
1. Funds (beginning of year)		
a) Reserve	$ 000,000	$ 000,000
b) Accumulated amounts on deposit	000,000	000,000
d) Provision for other accrued profits	00,000	00,000
f) Provision for unreported claims	00,000	00,000
h) Special contingency fund	000,000	000,000
i) Surplus	000,000	000,000
2. Totals	0,000,000	0,000,000
3. Various Revenue and Other Items, such as		
Premiums	$ 000,000	$ 000,000
Amounts left on deposit	000,000	000,000
Interest, dividends and rents	000,000	000,000
Profit on sale of securities	000,000	000,000
4. Totals	0,000,000	0,000,000
5. Grand Totals	0,000,000	0,000,000
6. Various Disbursements and Other Items, such as		
Claims	$ 000,000	$ 000,000
Deposits (including interest) withdrawn	000,000	000,000
Expenses	000,000	000,000
Loss on sale of securities	000,000	000,000
7. Totals	0,000,000	0,000,000
8. Funds (end of year)		
Headings as in item 1 above	0,000,000	0,000,000
9. Totals	0,000,000	0,000,000
10. Grand Totals (equal to item 5)	0,000,000	0,000,000

Appendix 3

Fig. 1

LIFE INSURANCE COMPANY

Statement of Profit and Loss and Surplus Accounts

(Illustrative Example)

INVESTMENT OPERATIONS

Revenue:—		
Interest, Dividends, Rents		$ 000,000
Profit on Investment Sales		000,000
		$ 000,000
Expenditures:—		
Losses on Investment Sales	$ 00,000	
Interest paid on Borrowed Money	00,000	
Investment Revaluations	00,000	
Depreciation, Buildings held for Use	00,000	
Investment Department Direct Expenses	00,000	
Equitable Share of General Overhead	00,000	
Net Result of Investment Operations		$ 000,000
Distributed as follows:—		
In proportion to a calculation of the mean amount of each fund invested during the year		
To Participating Insurance Operations	$ 00,000	
To Non-Participating Insurance Operations	00,000	
To Shareholders' Capital and Surplus	00,000	
To Other Funds not part of the General Operations	00,000	
To Depositors' Accounts (below) arising from:		
Participating Operations	00,000	
Non-Participating Operations	00,000	$ 000,000

Depositors' Accounts	*Participating*	*Non-Participating*
Interest Guaranteed by Supplementary Contracts	$ 000,000	$ 00,000
Share of Net Result of Investment Operations	000,000	00,000
Net Loss as a result of Interest Guaranteed transferred to Operating Accounts	$ 00,000	$ 0,000

Appendix 3

Fig. 2

LIFE INSURANCE COMPANY

Statement of Profit and Loss and Surplus Accounts

(Illustrative Example)

PARTICIPATING INSURANCE OPERATIONS

Opening Balances, January 1:			
Technical Inventory of Life Insurance and			
Annuity Reserve Liability:			
Minimum Government Requirement		$ 000,000	
Special Amounts Allotted, if any		00,000	
Total Participating Insurance Reserve, January 1			$ 000,000
Add Income:			
From Insurance and Annuity Contracts:			
First Year Premiums	$ 00,000		
Renewal Premiums	000,000		
Annuity Premiums	00,000	$ 000,000	
Credit from Investment Operations		00,000	
Total Income			000,000
			$ 000,000
Deduct Expenditures:			
Policies Terminated:			
By Maturity of Contracts	$ 00,000		
By Death of Insured	00,000		
By Annuities Paid	00,000		
By Surrender Values	00,000	$ 00,000	
Insurance Expenses:			
First Year Commissions	$ 00,000		
Renewal Commissions	00,000		
Annuity Commissions	00,000		
Agency Direct Expenses	00,000		
Share of General Overhead	00,000	00,000	
Guaranteed Interest Contracts:			
Loss on Depositors' Accounts		00,000	
Total Expenditures			000,000
			$ 000,000
Closing Balances, December 31:			
Technical Reserve Liability:			
Minimum Government Requirement		$ 000,000	
Special Amounts Allotted, if any		00,000	000,000
Net Profit transferred to Participating Surplus			000,000

Appendix 3

Fig. 3

LIFE INSURANCE COMPANY

Statement of Profit and Loss and Surplus Accounts

(*Illustrative Example*)

NON-PARTICIPATING OPERATIONS

Opening Balances, January 1:			
Technical Inventory of Life Insurance and Annuity Reserve Liability:			
Minimum Government Requirement		$ 000,000	
Special Amounts Allotted, if any		00,000	
Total Non-Participating Insurance Reserve, January 1			$ 000,000
Add Income:			
From Insurance and Annuity Contracts:			
First Year Premiums	$ 00,000		
Renewal Premiums	000,000		
Annuity Premiums	00,000	$ 000,000	
Credit from Investment Operations		00,000	
Total Income			000,000
			$ 000,000
Deduct Expenditures:			
Policies Terminated:			
By Maturity of Contracts	$ 00,000		
By Death of Insured	00,000		
By Annuities Paid	00,000		
By Surrender Values	00,000	$ 00,000	
Insurance Expenses:			
First Year Commissions	$ 00,000		
Renewal Commissions	00,000		
Annuity Commissions	00,000		
Agency Direct Expenses	00,000		
Share of General Overhead	00,000	00,000	
Guaranteed Interest Contracts:			
Loss on Depositors' Accounts		00,000	
Total Expenditures			000,000
			$ 000,000
Closing Balances, December 31:			
Technical Reserve Liability:			
Minimum Government Requirement		$ 000,000	
Special Amounts Allotted, if any,		00,000	000,000
Net Profit transferred to Non-Participating Surplus			$ 000,000

Appendix 3

Fig. 4

LIFE INSURANCE COMPANY

Statement of Profit and Loss and Surplus Accounts

(*Illustrative Example*)

SURPLUS ACCOUNTS

NOTE: *The Participating Surplus, the Non-Participating Surplus, the Shareholders' Surplus and the Shareholders' Capital in regard to the undistributed amounts remaining in the business are jointly and severally, by law, a Guarantee Fund to protect the policyholders against any extraordinary loss, such as a general catastrophe. It is this fact which appears to effectively prevent other than moderate regular dividends being paid to the shareholders.*

PARTICIPATING SURPLUS ACCOUNT

Opening Balance, January 1.		$ 000,000
Add:		
Net Profit from Participating Operations		000,000
		$ 000,000
Deduct:		
Distribution of Surplus to Policyholders:		
Annual Dividends Paid	$ 00,000	
Quinquennial Dividends Paid	00,000	
Total to Participating Policyholders 90%	$ 00,000	
Transferred to Shareholders Surplus 10%	00,000	00,000
Closing Balance, December 31.		$ 00,000

NON-PARTICIPATING SURPLUS ACCOUNT

Opening Balance, January 1.	$ 000,000
Add:	
Net Profit from Non-Participating Operations	00,000
	$ 000,000
Deduct:	
Transferred to Shareholders' Surplus	00,000
Closing Balance, December 31.	$ 000,000

SHAREHOLDERS' SURPLUS ACCOUNT

Opening Balance, January 1.		$ 000,000
Add:		
Transferred from Participating Surplus	$ 00,000	
Transferred from Non-Participating Surplus	00,000	
Credit from Investment Operations	00,000	00,000
Add:		
Annual Dividend to Shareholders	$ 00,000	
Income and Excess Profits Taxes	00,000	
Special Grants, if any,	00,000	00,000
Closing Balance, December 31.		$ 000,000

Profit Measurement And the Trade Cycle

By K. Lacey

A reply to E. F. Jeal's article in The Canadian Chartered Accountant of July

A British economist defends his case for the valuation of inventories always at market replacement cost and the transfer of inventory profits and losses to inventory reserve accounts, thus making profits independent of price fluctuations and minimising the effects of cyclical fluctuations in trade.

I SHOULD LIKE to make a few comments on Mr. E. F. Jeal's article in *The Canadian Chartered Accountant* for July, 1948 entitled "Profit Measurement and the Trade Cycle". His criticism of my article from The Economic Journal is welcome because it is only by means of constructive criticism that any progress is possible.

Support of Accountants Indispensable

First of all I agree wholeheartedly that the support of accountants is indispensable if the change of accounting procedure which I advocate is to be put into effect. But accountants have first to be convinced, and only a fairly forcible statement of the case for the change is likely to make any impression. The long tradition of existing accounting concepts is reinforced, as Mr. Jeal himself suggests, by legal traditional concepts based on money capital, and it has needed much logical argument over several years (the question has been under discussion in U.S. and British accounting circles since 1942 at least) to get accountants even to commence to reconsider their traditional approach. If in answering Mr. Jeal's points I still seem unduly provocative, it is hoped that these remarks will be borne in mind.

An Aspect of Collectivism?

Mr. Jeal appears to see my standpoint as an aspect of the new "collectivist" economy, and this appears to call for elucidation. It is true that a desire for the good of the whole community — such as the avoidance of booms and slumps — is behind many present-day writings, and that some of the conclusions reached are critical of present conventions or traditions. But it does not follow that what is good from a collective viewpoint is necessarily bad from the standpoint of a "particularist" economy. For example, in regard to the point under discussion, the treatment of inventory profits as "capital" profits to be put to an inven-

tory reserve is sound from the point of view of the private trader, since it ensures that he retains sufficient funds in the business to maintain the same volume of inventories and thus to maintain the same volume of business without going into debt. In fact, in Great Britain, it is private enterprise which has taken notice of the need for a new outlook on this question, and left-wing opinion, in the few cases where it has been voiced, has been critical.

In actual fact, criticism either from the "collectivists" or from the "particularists" is invalid, for the argument applies both to the private and the public sectors of the economy. No enterprise is sound unless it is recovering and retaining at least sufficient sales proceeds to replace the assets used up in production. But the only public enterprise, so far as I am aware, which accepts this approach is the British Cotton Commission (bulk buyer for raw cotton) which has been charging Lancashire spinners with replacement prices for their cotton. This policy was unpopular when cotton prices were rising, but now that a downward trend in cotton prices has come, the principle is better understood and appreciated.

We will now consider Mr. Jeal's specific points.

Influence of Accounting Statements

1. It is suggested that I overestimate the degree to which mercantile and investment action is implicitly guided by accounting summary statements periodically issued, and moreover, that comments can be and are issued to managements which cover various points, such as the inclusion of inventory profits and losses in the results. Now it would take up far too much space to reply to this point comprehensively and would involve long quotations from the article criticized. Instead of going over the old ground, let me ask two or three questions:

(a) In how many cases of recent new capital issues have the prospectuses given a reasonable intimation of the amount of inventory profits included in recent years' results? If the proposed approach is correct, then the failure to give this information involves misleading the public, but accountants must themselves (on my argument) be sufficiently misled to consider that no obligation rests upon them to disclose this information.

(b) In how many cases during the slump years 1930-32 were stockholders told, (a) that profits were abnormally low because of the large inventory losses charged against results, (b) that these were not losses of substance, and (c) that the position was not really so bad as the published results indicated? Such a statement in those years would have been regarded as quite incomprehensible.

(c) If it is accepted that at least a report should be made showing the extent to which results are distorted by changes in the value of money, what is the objection to making the necessary adjustments in the accounts themselves? Calculations would have to be made with reasonable precision in order to incorporate the information in the report, and in my view it would be an advantage to adjust the accounts themselves, by means of transfers to and from an Inventory Reserve and a Fixed Asset Replacement Reserve. Such a basis of income reporting would show

quite clearly how far profits as now computed were needed in the business merely to maintain the same volume of assets and how far they were available either for distribution or for expanding the physical scope of business activities.

Benefit of Shrewd Buying Not Eliminated

2. Mr. Jeal sees a source of criticism in the fact that one cannot differentiate between rises (or falls) in prices of the goods dealt in by a business which are ascribable to so-called "extensive" factors — i.e. inflation or deflation — and those concerning changes in intensive demand for the goods. He seems to imagine as a result that the basis I suggest would eliminate from the trading account the benefit of shrewd buying.

This is a misconception. The benefit of shrewd buying must be reflected in the accounts whether the conventional basis or the proposed new basis is employed. The drawing up of accounts on a replacement cost basis merely affects the *period* in which credit is taken for that shrewd buying. At present the credit is taken in the period in which the good are *sold,* whereas under the replacement cost basis the credit is normally taken in the period in which the goods are *bought.* Since, owing to shrewd buying, it has cost less to replace certain good sold, the profit on the sale of these goods (on the replacement cost principle) is correspondingly higher, and the benefit of the shrewd buying is therefore immediately reflected in the results.

Let us, for the sake of argument, reverse the present situation and assume that the replacement cost basis is the accepted one, and that someone has suggested that the actual cost basis is better. In such circumstances, it would be comparatively easy to show how absurd was the suggested new basis (actual cost) because of the recorded effect of good or bad buying. The new basis — so would run the criticism — would involve the introduction into the results of inventory profits or losses; if buying were inefficient, then closing inventory values at actual cost would be higher, there would be higher inventory profits and hence higher total profits; thus, the result of inefficient buying would be to increase the profits (in comparison with results on the replacement cost basis)—which is absurd. Similarly, if buying were keen, then closing inventory values at actual cost would be lower, there would be inventory losses, and therefore lower total profits; thus the results of shrewd buying would be to reduce the profits (in comparison with the replacement cost basis)—which again is absurd.

The above hypothetical criticism is not, of course, quite justified, for the peculiar effect of good or bad buying upon closing inventory values and hence upon results is reversed in the next period when the goods in question are actually sold. But the illustration should at least make it clear that the replacement cost method does reflect the benefit of shrewd buying, and (I would argue) in a more appropriate period than at present, i.e. in the period in which the buying has taken place. The benefits of keen buying or the disadvantages of inefficient buying are not, so to speak, carried in suspense until the goods are disposed of.

Accountants Not Consistently Conservative

3. Mr. Jeal says that accountants have argued that conventional procedure suffices if applied consistently, also that accountants have tended towards conservatism in the application of law by empiric methodology coloured by notions

of convenience and expediency. Now I certainly agree that the sincerity of accountants on these topics is unquestionable. My aim has merely been to show that the tendency to conservatism is not so consistent as accountants imagine, and therefore that conventional procedures do not suffice. Accountants are under the impression that because they do not write up inventory values they are being conservative. But inventory values on present conventions rise considerably without any deliberate write up, and accountants are far from conservative when replacement costs are rising. Similarly, inventory values can fall considerably without any deliberate write down, and accountants are ultra conservative when replacement costs are falling. Thus there is a change from insufficient conservatism to ultra conservatism which I am convinced has some effect in intensifying the slump.

The object of my various articles has been to convince accountants of the need for urgent thought upon this subject. Many businesses are finding that the whole of their substantial reserves created out of profits since 1939 have been swallowed up in increased replacement costs of their inventories alone, so that in many cases new capital has had to be raised to finance the increased replacement cost of fixed assets. This shows the extent to which accounts as now drawn up do tend to mislead in circumstances of changing prices, for until recently profits have appeared, if anything, unduly large, and reserves have seemed more than adequate for all circumstances.

Professional Notes

MANITOBA

G. M. Horne & Company, Chartered Accountants, announce the removal of their office to 311 Avenue Building, Winnipeg, Manitoba.

SASKATCHEWAN

Zaitlen & Zaitlen, Chartered Accountants, announce the removal of their offices to 409 MacMillan Building, Saskatoon, Saskatchewan.

QUEBEC

S. S. Matthews and Company, Chartered Accountants, announce removal of their offices to 619 Notre Dame Street West, Montreal, Quebec.

* * *

Mr. T. Cecil Davis, Chartered Accountant, has been appointed Comptroller and Assistant Treasurer of the St. Regis Paper Company (Canada) Limited, Montreal, Quebec.

Obituary

The Late William C. Benson

The Ontario Institute announces with deep regret the sudden passing of Mr. William Charles Benson on November 16 at his home in London, Ontario. Mr. Benson was born in Cobourg in 1877 and became a member of the Ontario Institute in 1905. For some years he was associated with Oscar Hudson and Company in the practice of his profession but more recently he formed his own firm of W. C. Benson and Company. He served on the Council of the Ontario Institute in 1947 and in 1948. He was also prominent in the activities of the Y.M.C.A.

To his widow, son and sister the Institute extends its sincere sympathy.

I Married A C.P.A.

Anonymous

A delightful account of the adventures that befall those who marry into the profession.

SOME women marry explorers and go to darkest Africa and get their pictures taken in kodachrome for The National Geographic Magazine. Others marry foreign correspondents and go off to write gay, lilting tales of life abroad. Then there are the women who marry diplomats and doctors and make their lives sound like one crucial incident after the other. But none can compare with the adventures that befall those of us who marry into the chosen profession, the gift to the business world and to American womankind — the C.P.A.

A Life of Adventure

We may not go over Niagara Falls in a barrel, but apart from the usual domestic and spiritual upheavals occasioned by the approach of the Ides of March, life with a C.P.A. supplies its own particular adventures and crises. For instance, there was *The Adventures of the C.P.A. in Sheep's Clothing,* or a reasonabel facsimile. My C.P.A. wore small patterned foulard ties: red background and black diamonds for the oxford gray suit with the bookkeeper-slouch shoulders and the almost indiscernible blue stripe eight inches apart; brown background for the appropriate dark brown suit; and so on. All of this was topped off by a pair of rimless glasses, lending the proper touch of dignity and conservatism that is such an indispensable part of the accountant's professional appearance. Can you picture the feeling of pride I felt when I finally saw my C.P.A. dressed in a glen plaid suit with an infinitesimal drape, a hand-tied bowtie, gazing at the world around him through a pair of horn-rimmed spectacles (genteel-looking glasses, but horn-rimmed just the same)? I should confess, though, that it was with a feeling akin to that of Frankenstein's creator that I saw the latest pair of horn-rimmed glasses he chose, and the newest dynamic (to put it politely) addition to a tie-rack that blazons forth with an almost oriental-like splendor. (Note—As a result of a recent sartorial survey conducted by me at a meeting of the New York State Society of C.P.A.'s., I am pleased to announce that the change in the membership's clothing habits appears to be one of the most overwhelming examples of recent progress in the accounting field.)

Delights From the Mail Bag

Do you know what you are missing if your husband gets all his professional mail at the office? There are the endless CCH reports, some of which are

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marked "Important—Latest Market Survey" (the postman has stopped ringing the bell frantically when he sees them); the financial statements of all sizes, colors, descriptions and companies, most of which have a certain beauty from an aesthetic point of view, but make very dull reading; the white envelope containing *The Accountants' Weekly Newsletter;* the *Journal of Accountancy*, with a nice new printing job, but perhaps they should vary the color of the cover each month in the same fashion that *Harper's* does; all the notices, literature and magazines from the New York State Society, plus the rhythmic sounding lists of people who passed the examination, who wished to become associate members, who wish to become full members, and who are raised to full membership. These are placed on the desk each morning, and each evening we make room for the collection of literature my husband doesn't get a chance to read at the office and so brings home. There are the Prentice-Hall service reports, *The Tax Magazine, The Comptroller,* the innumerable booklets put out by Merrill, Lynch, Pierce, etc (more familiarly known in our house as "We, the People"), SEC releases and bulletins, Research Institute of America surveys in blue and white covers that do not match our décor. Once a month, I carefully arrange all this material. Once every three months I issue an ultimatum—either that desk gets cleaned off or else—and still the piles stretch skyward *ad infinitum.* Who's henpecked?

Enlightenment and Literature

Our bookshelves are enlightening, too. Next to a beautiful edition of *The Count of Monte Cristo* is a copy of *Fraud, Its Control Through Accounts.* Fjeld and Sherrit have found refuge among Thomas Mann's volumes on *Joseph.* Kester seems to be supporting *Take It Easy Before Dinner* (a new approach to cooking), and I have found that Holmes on *Auditing* and Neuner on *Cost Accounting* provide the perfect backbone fore and aft for the best collection of paper-backed mystery stories in a radius of three blocks. *Estate Accounting and Taxation* waits expectantly near *The Decline and Fall of the Roman Epire,* while *Practical Budget Procedure* droops dejectedly next to *First Aid for the Ailing House.* If there are empty spaces on your shelves, despair not! Comes the next tax law revision and you can, with no difficulty at all, cajole your husband into bringing home the forty-three interpretations of the aforesaid revision that he has undoubtedly received. Never, never throw out this collection because it may come in handy when one of the Federal, state and city tax forms, collected since 1918, may be used!

Accounting in the Home

But let us be open-minded. Let us look at it from the other point of view: At least once a year, when things are not quite so hectic in the profession, comes a familiar glint in my husband's eye. The next day he usually appears with a present for me—a new variation of a budget book. We thereupon enter upon a period of carefully noting all expenditures. After two weeks of this, I'm told I can drop all the pennies and round off the figures. One week thereafter, it becomes apparent that I use too many classifications and, instead of headings like Presents to Close Relatives, Presents to Relatives Once Removed, and Tips to Oil Delivery Man, Grocer and Fruitman, I can use something simple — like Miscellaneous. After two weeks of this, it is quite easy to see that the bulk of our expenditures fall naturally into the Miscellaneous grouping, and the budget book soon dies a natural death. I have a wonderful

plan for never being short or over while the plan is in use. Just work back from what you have left!

Next, to my shame, comes the checkbook manipulations. Because my husband used to spend a good deal of time out-of-town, the chore of balancing the checkbook was mine and I was strictly on my own. Then came the time I was rash enough to admire a man who made out checks and never filled in the stubs or entered deposits. An ideal situation, I said. From that day on, I have been most carefully audited.

"What is this adjustment of $2.34 at the end of the month?" I am asked.

"Oh, my balance didn't agree with the bank and they never make mistakes, so I adjusted." Now I know that it is a fundamental principle of auditing that even a penny error in cash must be carefully checked because it might cover a defalcation of $452,693.88! But this is *our* checkbook.

"You mean you didn't even look for the error?" said my C.P.A. in a tone of rising horror and incredulity.

$$xy \div 9 + 2 = yx!$$

"Oh," I answer fliply enough, "I know what the $2.34 is. I always make errors in addition of two. That's the two dollars. The thirty-four cents must have been a transposition. Yes, I know that transpositions are usually divisible by nine, but then I must have made another error in addition of two cents and that explains the three and four which equals seven, or nine minus two. So you see, I really didn't have to spend time looking for the error."

I do not recommend this as an ordinary diet, particularly if your husband is subject to the accountant's occupational disease of ulcers. But if you are patient enough, there will yet come the day when your husband makes out checks and does not even take the trouble to enter them. Don't turn the screw then, mesdames!

I always fill in the check stub carefully. "Butcher—$27.86." 'No, dear, it is not for two months—didn't you know that the cost of living went up again? Yes, dear, the household allowance should be sufficient, but I lent Elsie eight dollars and then I bought that lovely ashtray for six dollars. Of course, Elsie returned the eight dollars, but I didn't have enough cash for the butcher anyway; so I made out a check for the whole amount. No, I don't have any money left — I had my hair done; and then your whole family stayed to dinner and killed off that roast." Why do C.P.A.'s. wear that harassed look?

If that doesn't help, there is always the exchange check deal: "Sister—exchange — $40.00" is what the check stub says. The deposit side says "Sister — exchange — $15.00". Don't ask me to explain further, because it is all so abundantly clear; or isn't it?

After we saw "Life with Father", I subtly reminded my husband that apparently a wife's financial failings were not unusual and were, in fact, like women drivers, if you know what I mean.

My husband not so subtly summed up the entire situation when he regarded me with a baleful eye over those frightening glasses and succinctly said, *"Yes, but Father wasn't married TO a C.P.A."*

CORRIGENDA

In the article "Some Remediable Defects in Published Accounts" by Cecil A. Ellis, C.A., in the November issue, the three columns at the foot of page 250 should have been headed, "1st year — 2nd year — 3rd years" and the last figure on the page should have been $82,859.

Accountants Cavort In Country Capers

By H. A. Hunt, C.A.

The Chairman of the Entertainment Committee relates the trials undergone by those who made arrangements for that famous barn dance at Regina in August.

In order to have a barn dance, it was necessary that we find a barn. That meant visiting almost every farm that had a hayloft within a radius of 17 miles of Regina. After 3 trips and numerous phone calls, we found one farmer who didn't say no. (Up to this point we were not just talking to farmers' daughters either). We gleefully said "Thanks, very much", and that we would look after cleaning it up. So on Monday afternoon, one of the hottest days of the summer, four of us journeyed forth to move hay to one corner of the loft. After 2 hours on the end of a pitchfork and broom, we decided pen-pushing was not too bad a life after all, having discovered that on the removal of the top layers a certain material still clung to the floor.

The night of the barn dance all began on schedule and the refreshment section was set up in short order. But for some reason the orchestra did not appear to be getting under way. It developed that the battery of the loud speaker equipment was dead, and as any man knows, a battery must be charged in order to produce. After much searching, one of the members was located who not only knew he had a battery in his car but also knew how to take it out and was at the same time willing to lend it for the good of the cause. He was dancing with a very lovely partner when cornered. Action will be initiated to ensure that his sacrifice is recorded for posterity.

At a certain point the band leader was all for declaring the official twenty minute stoppage which all good followers of Mr. Petrillo are required to recognize in the course of the evening's performance. But we just couldn't permit a break for fear of a serious run on the rapidly depleting stocks of the refreshment committee. This shortage was further aggravated by a number of the farmer's neighbors who "just happened to drop in" and whom we were unable to segregate from our own thirsty following gone native. Further, arrangements had been made for the piano to be returned to town at 1:30 a.m. and the truckers were especially prompt in arriving, doing so in fact before anybody else. It appeared that the poor lads must have been unusually dry as they were among the best customers of the refreshment booth, so much so that the booth was all for regulatory legislation which was shelved — as is so often the case — on this occasion, as the truckers were clients of our local president!

Eventually lunch was served and the music was even slightly audible above the din. All was fairly serene, barn dance fashion, and it broke up on a fairly high note. We still await the account for repairs to the piano. It had such a tough time getting back onto the van, the truckers, no doubt being very tired after such a strenuous evening, seeming particularly weak at this late hour. The last car moved off with yours truly aboard when we saw the piano loaded. Our last glimpse of the barn was of the farmer peering around with a lantern trying to recognize his place.

A New Treatise On Accounting

Accounting Principles and Practice, by Professor R. G. H. Smails, B. Sc. (Econ.), F.C.A., (Ryerson Press, Toronto, 1948), 461 pages and index, $5.50.

"The function of bookkeeping is not merely to create a complete and accurate record of all transactions but to do this with the greatest possible efficiency and the least possible effort." (p. 19.)

In the first fifteen pages of his new book *"Accounting Principles and Practice"* Professor Smails skillfully conducts one by a very simple route, through the "Bookkeeping Cycle" by way of "John Casey's Furniture Business". He then proceeds, on the next twenty-three chapters, to enlighten and instruct his readers in bookkeeping procedures and in the art of accounting.

As stated in the preface "this is not a revision of Smails and Walker, *"Accounting Principles"* but rather a successor volume". The sequence of the chapters has been changed and new chapters covering the following topics have been added: The Ledger in Modern Bookkeeping, Accounting Reports; Partnership Accounts—Dissolution; The Accounts of a Limited Company—Consolidations; Reorganizations; Theory of Income Measurement; Published Reports of Companies. While it is primarily a treatise for students of accounting, it is something more than a text; it is a most valuable accounting reference work, useful to anyone concerned with the recording of financial transactions and the preparation of financial reports.

Academic colleagues of Professor Smails should welcome the appearance of this latest contribution to the body of Canadian accounting literature. It places on record for them, and for their students, an up-to-date presentation of Canadian practice and procedures, especially those with reference to "Bills of Exchange and Promissory Notes", and "The Accounts of a Limited Company," which is not covered in the American accounting works widely used in this country. His intimate knowledge of commercial and statute law has enabled him to weave into the context material significant and relevant to the procedures under discussion. Sometimes, however, the use of technical terminology is apt to confuse an unwary reader, as for example, the use of the legal term "issue" in connection with share capital, which Professor Smails associates with allotment, but which the student may associate with issue of share certificates. (p. 268, 269, 271.) However, it is encouraging to note the clarification of the approach to accounting for share capital and the consideration given to the current practice of marketing shares through an investment house.

For students-in-accounts, each chapter contains a wealth of illustrative material which the author presents in an interesting setting, organizing and co-ordinating it so as to put the student "into the picture." Smails goes much further than a mere recital of the entries for particular transactions, and one is impressed by the attention given, not only to accounting principles, but also to administrative procedures.

Professional accountants will appreciate the trend his writing has taken in "reaching out" for a more generally acceptable accounting terminology or vocabulary. In dealing with the avoidance of the use of technical terms (p. 46) he says:

"(These cannot be avoided entirely and that circumstance is responsible for much unmerited criticism of accountants and their words by those who rely on accounting reports but are unwilling to learn the meaning of technical words which cannot be translated or of conventions whose use is inevitable) . . . . In short. an accounting report is to be regarded not as an end in itself (the crowning glory of the accountant's edifice) but as a means whereby others may gain the sort of information which an accountant should be able to give them."

Attention is called to the danger inherent in seriatum deductions in profit and loss statements and the use of the term "margin" is suggested in place of "profit" (p. 50). In his discussion of reserves he states (p. 154):

"Practice appears to be moving in the direction of dropping the use of the word reserve in reference to both asset valuation and liability reserves and of substituting the word provision. This practice is to be encouraged for it helps to dispel the terminological fog which envelopes the subject of accounting reserves."

One wishes that Professor Smails could have found it possible to lead the way out of this "terminological fog" by the definite acceptance of some of these innovations.

Lest it may be thought that the Professor is merely a narrator of trends, attention is directed to one of his more succinct phrases in which he supports the contention that unamortized bond discount should be deducted from the par value of the bond liability (p. 324):

"Too often bond discount is set out on the assets side of the balance sheet as a prepaid expense or deferred charge. It is neither of these; it is not an asset of any kind. It is an amount which the company has contracted to borrow but which it has not yet borrowed."

On the other hand, the professor's readiness to accept some innovations is illustrated in his chapter "The Manufacturing or Work in Process Accounts." Discussing factory overhead expense he observes (p. 129):

"For this reason some writers (including the author of this text) prefer the term factory service costs to the term overhead expense."

This reviewer must beware lest he confuse this terminology with the cost of service departments to be distributed to productive departments.

This book has been written on a high intellectual and professional level. It gives the reader a sound appreciation of accepted accounting principles and procedures and of the legal aspects connected therewith which, during his long and successful teaching and professional career, Professor Smails has found of value and worth recording.

J. H. THOMPSON.
University of Saskatchewan.

The Tax Department

Cases • Regulations • Directives • Comment

Edited by M. I. Pierce, B.A., LL.B.

Recent Tax Cases

Bennett & White Construction Co. v. Minister of National Revenue

(*Supreme Court of Canada, Rinfret C.J.C., Rand, Kellock, Estey and Locke JJ. October 5, 1948*)

Deductible Expenses — Sums paid guarantors of Bank loan — Not laid out "wholly, exclusively and necessarily" to earn income — Payment on account of capital — Income War Tax Act, secs. 5(1)(b), 6(1)(a) and (b)

Appellant company was engaged in the general contracting and construction business. Because its paid-up capital and surplus were insufficient to finance the volume of business which was offering, amounting to more than $3,000,000 in each of the years 1941 and 1942, the company obtained the necessary additional funds from a bank under a line of credit, but as security therefor were required to furnish the bank with personal guarantees from the company's principal shareholders, the amount so guaranteed being $370,000 in each of the years 1941 and 1942. The company obtained the guarantees by undertaking to pay the guarantors an amount equal to the interest paid the bank in each year. The funds so obtained from the bank were used to provide deposits on going contracts, for payrolls and for the purchase of materials and equipment. The interest paid the bank on the moneys borrowed was allowed as a deduction from the company's income in each year, but deduction of the sums paid the guarantors in each of the years 1941 and 1942 was disallowed. The company appealed.

Held (affirming the judgment of O'CONNOR J. in the Exchequer Court): The sums paid to the guarantors were not laid out wholly, exclusively and necessarily for the purpose of earning the income within the meaning of section 6(1)(a) of the *Income War Tax Act*, but were payments on account of capital and therefore prohibited from deduction under section 6(1)(b). The appeal must therefore be dismissed.

Per LOCKE J. (RINFRET C.J.C. and KELLOCK J. concurring): While the amounts paid to the guarantors were described as interest in the various resolutions which authorised their payment, this was clearly inaccurate. Interest is paid by a borrower to a lender: a sum paid to a third person as the consideration for guaranteeing a loan cannot be so described.

Having regard to the distinction between expenditures laid out for the purpose of earning the profits and those made for the acquisition of property or of permanent rights, the possession of which is a condition of carrying on the trade at all [*Addie* v. *C.I.R.* [1924] S.C. 321 at p. 325, approved by the Privy Council in *Tata Hydro-Electric Agencies Ltd.* v. *Com'r of Income Tax* [1937] A.C. 635 at p. 695], and to the distinction between expenditures made in providing capital for an enterprise and those for the carrying on of the trade from which its earnings are derived [*Montreal Coke and Mfg. Co.* v. *M.N.R.* [1944] A.C. 126], a sum expended as interest for the use of capital is clearly to be distinguished from expenditures made to obtain a guarantee without which a loan would not be made, which do not differ in essence from those which were disallowed in the *Montreal Coke* case, viz., expenses incurred in the redemption and conversion of bonds on less onerous terms. Expenditures such as these made by reason of the necessity of obtaining working capital are payments "on account of capital" within the meaning of sec. 6(1)(b) of the *Income War Tax Act* and are not deductible.

Per RAND J.: To be wholly, exclusively and necessarily laid out to earn the income an expenditure must have to do with the earning of income through the use of capital funds which in one form or another constitute the means and instruments by which the business is prosecuted, but the provision or organisation of such capital funds must be clearly distinguished from the business itself: *Montreal Coke* case. In the absence of statute, it seems to be settled that to bring interest paid on temporary financing within deductible expenses, the financing must be an integral part of the business carried on, as e.g., in the daily buying and selling of securities [*Farmer* v. *Scottish North American Trust* [1912] A.C. 118], or the lending of money as part of a brewery business [*Reid's Brewery* v. *Mail* [1891] 2 Q.B. 1]. The allowance of the deduction of interest paid to the bank must have been on the footing that the day-to-day use of the funds was embraced within the business that produced the profit, or that the interest was within sec. 5(1)(b) of the Act. But setting up that credit right or providing the banking facilities is quite another thing from paying interest; it is preparatory to earning the income and is no more part of the business carried on than would be the work involved in a bond issue; it is outside the circumference of the transactions from which the income arises. The payments in question create part of the capital structure and are thus a capital payment: *Watney* v. *Musgrove*, 5 Ex. D. 241. They furnish a credit apparatus to enable the business to be carried on, and although they affect the distributable earnings of the company, they do not affect the net return from the business.

Per ESTEY J.: The guarantee was an asset which the company purchased to enable it to borrow the funds necessary to do the volume of business which it undertook. The money was borrowed not for a temporary purpose and as an incident in the company's ordinary business operations, but rather, having regard to the practice followed and the use of the funds to expand the business, for an indefinite period and therefore, in the commercial sense, constituted an increase in capital: [*Scottish North American Trust* v. *Farmer* (1911) 5 T.C. 693]. The fact that the bank computed interest from day to day, that payments were made on account thereof as funds were available and that the loan would be repaid if construction contracts were at any time not available did not affect the character of the loan as essentially permanent in character and therefore as being capital [*European Investment Trust Co.* v. *Jackson* (1932) 18 T.C. 1; *Scottish North American Trust* case, *supra*, *Associated Gas Water Heater Ltd.* v. *Duff* (1942) 24 T.C. 161; *Southwell* v. *Savill Bros. Ltd.* [1901] 2 K.B. 349, considered]. The payments made are in principle identical with those dealt with by the Privy Council in the *Montreal Coke* case, where it was emphasised that under sec. 6(1)(a) an expenditure must be directly related to the earning of income to be deductible and that expenditure incurred in relation to the financing of a business is not within the statutory allowance. The payments in question were made not as interest on money borrowed but as the purchase price

for the guarantee that made the borrowing possible, the obtaining of which enabled the company to complete its financial arrangements at the bank and thus to undertake the larger volume of business. Sums borrowed under such circumstances are capital and not deductible under sec. 6 (1)(a).

Appeal dismissed.

Fasken's Executors v. Minister of National Revenue

(*Exchequer Court of Canada, Thorson P., October 8, 1948*)

Transfer of property by husband to wife—"Transfer"—"Property"—Income War Tax Act, 1917, sec. 4(4); 1926, c. 10, secs. 7, 12; R. S. C. 1927, c. 97, sec. 32(2)—Whether retroactive or prospective—Molson v. M. N. R. disagreed with.

In 1913 Fasken advanced a large sum of money to a company to enable it to purchase a farm in Texas, and the company periodically gave acknowledgment of its indebtedness therefor to Fasken. Later the acknowledgment of indebtedness was made to trustees instead of to Fasken personally, and by instrument dated December 31, 1924 the company undertook to pay such indebtedness to the trustees on demand, and to pay interest thereon commencing July 1, 1925. By declaration of trust under the same date the trustees simultaneously declared, *inter alia,* that they would pay a part of the interest so received to Fasken's wife.

In the years 1925 to 1929 inclusive payments were made to Fasken's wife pursuant to the two instruments dated December 31, 1924. Fasken died in 1929, and in 1944 his estate was additionally assessed in the amount paid in each of such years to his wife as aforesaid. Fasken's executors appealed.

The relevant statutory provisions are as follows:

Income War Tax Act, 1917, c. 28:

> 4(4). A person who, after August 1, 1917, has reduced his income by the transfer . . . of any . . . property, to such person's wife or husband . . . shall, nevertheless, be liable to be taxed as if such transfer . . . had not been made . . .

Income War Tax Amendment Act, 1926, c. 10:

> 7. Section 4(4) of the Income War Tax Act, 1917, c. 28 is hereby repealed and the following substituted therefor:—
>
> "4(4). For the purposes of this Act,—
>
> (a) . . . . . .
>
> (b) Where a husband transfers property to his wife, or *vice versa,* the husband or the wife, as the case may be, shall nevertheless be liable to be taxed on the income derived from such property . . . as if such transfer had not been made."
>
> 12. Section 7 . . . shall apply to the year 1925 or fiscal periods ending therein and to all subsequent years or fiscal periods, and to the income thereof.

Income War Tax Act, R.S.C. 1927, c. 97:

> 32(2). Where a husband transfers property to his wife, or *vice versa,* the husband or the wife, as the case may be, shall nevertheless be liable to be taxed on the income derived from such property or from property substituted therefor as if such transfer had not been made.

Held: The appeals must be allowed. The enactments of 1926 and 1927 were not retroactive but applied only to transfers made after they came into effect, viz., Jan. 1, 1925 in the case of the 1926 enactment. Therefore, although there was a "transfer" of "property" from which income was derived within the meaning of these enactments, such transfer was not subject to their provisions,

since it must be presumed to have been made on the date stated in the two instruments dated December 31, 1924. Finally, section 4(4) of the 1917 Act did not apply, since it was essential to the application of this provision that both the transfer and the reduction in income resulting therefrom occur during the time such enactment was in force; here, while the transfer took place on December 31, 1924, the reduction in Fasken's income resulting therefrom did not occur until afterwards when the 1917 provision was no longer operative.

NOTE

While the actual decision in this case is of narrow interest, the elaborate reasons given by Thorson P. on a number of questions are of much broader concern, and are summarized following:

(1) "Property" and "Transfer"

Referring to the rule of strict construction applicable to taxing Acts, Thorson P. said:

"All that is meant [by this rule] is that in construing a taxing Act the Court ought not to assume any tax liability under it other than that which it has clearly imposed in express terms. [*Partingdon* v. *Att'y-Gen.* (1869) 4 E & I. App. 100 per Lord Cairns at p. 122; *Tennant* v. *Smith* [1892] A.C. 150 per Lord Halsbury at p. 154]. Obviously, the rule of strict construction, understood in the sense indicated, is applicable to the sections of the Act under review, under which it is sought to make the taxpayer liable for income tax on income which he himself has never received."

His Lordship stated that it is also a cardinal rule of interpreting words in a taxing Act, that unless the context otherwise requires or unless words have a technical and legal meaning, they should be read in the sense in which they are ordinarily used [*Grey* v. *Pearson* (1857) 6 H.L. 60, per Lord Wensleydale at p. 106; *Smelting Co. of Australia* v. *C.I.R.* [1896] 2 Q.B. 179 per Pollock B. at p. 184; *I.R.C.* v. *Herbert* [1913] A.C. 326, per Lord Haldane at p. 332; *Com'rs* v. *Pemsel* [1891] A.C. 531], and that dictionaries may properly be consulted for guidance as to the meaning of words in their ordinary sense [*Midland Ry.* v. *Robinson* (1890) 15 App. Cas. 19, per Lord Macnaghten at p. 34; *The Queen* v. *Peters* (1885-6) 16 Q.B.D. 636, per Lord Coleridge C.J. at p. 641].

Pointing out that the word "property" is a term of wide import, and citing its broad definition in standard dictionaries and in decided cases, e.g. *Jones* v. *Skinner* (1836) L.J. (N.S.) Ch. 87, per Lord Langdale, M.R. at p. 90, Thorson P. concluded that the word "property" as used in the Act was clearly wide enough in meaning to include the right accorded Fasken's wife to receive from the trustees interest on the company's indebtedness. For similar reasons (see *Gathercole* v. *Smith* (1880-81)) the word "transfer" is not a term of art and has not a technical meaning, and it must be concluded that a transfer is effected, where a husband so deals with property as to divest himself of it and vest it in his wife; the means by which he achieves this may properly be called a transfer, and that was what had taken place between Fasken and his wife.

His Lordship added that the property transferred was not the interest on the indebtedness, which, it might be urged, was outside the contemplation of the Act, but the right to receive interest on the indebtedness which was within the contemplation of the Act. (His Lordship added that he reached this conclusion notwithstanding the enactment of sec. 32(4) in 1939 which specifically brought a transfer of the right to income within the operation of the section).

(2) Intent To Evade Tax Unnecessary

Thorson P. rejected appellant's contention, founded on Angers J.'s judgment in *Molson* v. *M.N.R.* [1937] Ex. C.R. 55, that the enactments in question applied only where the transfer was made to evade taxation. Thorson P. disagreed with this view on the ground that the marginal notes and headings which accompanied these provisions ought not to have been referred to for the purpose of interpreting the enactments in question, there being no ambiguity therein [*Hammersmith and City Ry. Co.* v. *Brand* (1869) 4 H.L. 171; *Fletcher* v. *Birkenhead* [1907] 1 K.B. 205 at p. 214]. Moreover, he added, there was no marginal note or heading attached

to the 1926 enactment stating that the section related to "transfers to evade taxation", and inasmuch as sec. 32(2) of the 1927 Revision was merely declaratory of the pre-existing law [*An Act Respecting the Revised Statutes of Canada*, 1924 (Dom.), c. 65, sec. 8], no such construction could attach to sec 32(2). Finally, he said, where the words in a statute are clear, conditions of liability thereunder or exemptions therefrom cannot be read into it by implication.

(3) Prospective Construction

Thorson P. concurred in appellant's contention that liability to tax for the years 1925 to 1929 must be determined by the law in force in those years, namely sec. 4(4) as enacted by sec. 7 of 1926 (Dom.), c. 10, from January 1, 1925, to which date it was made retroactive by sec. 12 of such Act, up to Feb. 1, 1928, when sec. 32(2) of R.S.C. 1927, c. 97, came into effect, and thereafter by such sec. 32(2). Thorson P. said that the word "transfers" in these provisions could not be read to mean "has transferred", and that it therefore applied only to transfers made on or after January 1, 1925. To hold otherwise would be to violate the rule of strict construction and the rule that a statute will only be accorded a retrospective operation if such intention clearly appears or arises by necessary and distinct implication: *Maxwell on Interpretation of Statutes*, 9th ed., p. 221.

(4) Date of Transfer

Thorson P. pointed out that there was no evidence as to the actual date of the execution of the transfer by Fasken to his wife, and that it must therefore be presumed that the documents were executed on the day they bore date, viz., December 31, 1924: *Phipson on Evidence*, 8th ed., p. 506. His Lordship rejected respondent's contention that the transfer was not complete until the shareholders of the company ratified such acknowledgment on January 6, 1925 when a resolution was passed directing that security be given the trustees for claimants against the company *or their assignees.* Not only was this not a ratification but no ratification was necessary as the acknowledgment was fully authorised by a prior resolution of the company. There was no substance to the contention that because Fasken's wife was not to receive any income until after January 1, 1925, there was no transfer until after that date; the property transferred was not the interest but the right to receive it.

(5) Molson Case Questioned

Reference was made to *MNR* v. *Molson* [1938] S.C.R. 213, in which the majority of the Supreme Court of Canada held that because of the non-reenactment of section 12, of the 1926 Act in the 1927 Revision, the retroactive application of section 7 of the 1926 Act (assented to on June 15, 1926) had ceased and that consequently a transfer on March 23, 1925 was not within sec. 32(2) of the 1927 Revision. Thorson P. said that even if this view were correct in respect of income arising after the coming into force of the 1927 Revision, viz., February 1, 1928, it could not apply to the period when the 1926 provision was in force, namely January 1, 1925, to February 1, 1928. Pointing out that the above judgment was rendered, in accordance with the agreement of counsel, on the basis that the decision for the year 1930 should apply to all the years in question, Thorson P. said that as a result there was no adjudication on the validity of assessments for the period prior to February 1, 1928. He added:

> "An appeal from an income tax assessment is not a private dispute between the appellant taxpayer and the Minister or a *lis* in the ordinary sense, in which the agreement of counsel may bind the parties thereto and so preclude the Court from dealing with the issue of the appeal on its merits; the public has an interest in the disposition of the appeal and in seeing that taxpayers are held liable for the tax which Parliament has imposed upon them and that no taxpayer is released therefrom pursuant to an agreement of counsel and the acquiescence of the Court in its application. It is the duty of the Court in such an appeal to determine the liability of the taxpayer under each assessment appealed from according to the law which Parliament has made applicable to it regardless of what agreement counsel may have made as to its disposition."

Thorson P. also disagreed with the judg-

ment in respect to the period subsequent to February 1, 1928. In his view the 1926 enactment (with its retroactive effect) was preserved in unbroken continuity by section 32 (2) of the 1927 Revision [*An Act Respecting the Revised Statutes of Canada*, 1924 (Dom.), c. 65 secs. 2, 5(2)].

(6) Sec. 4(4) of 1917 Not Applicable

Thorson P. rejected respondent's final contention that liability was preserved under sec. 4(4) of the original Act of 1917 in unbroken continuity notwithstanding its repeal by the 1926 Act with retroactive effect to January 1, 1925. A change in the law was, he said, effected by the 1926 legislation, which did not, like the 1927 amendment, re-enact the existing legislation without change. Therefore sec. 4(4) of the 1917 Act ceased to have effect on its repeal except as to accrued rights and obligations thereunder. [*Intrepretation Act*, R.S.C. 1927, c. 1, sec. 19]. Sec. 4(4) could thereafter apply only to a transfer of property and income derived therefrom if the transfer was made (1) when sec. 4(4) was operative and (2) there was a reduction in the transferor's income during such time. Here, while the transfer was made during such time, viz., December 31, 1924, there was no reduction in Fasken's income until interest was paid to his wife in 1925, at which time sec. 4(4) was inoperative due to its repeal with retroactive effect by the 1926 enactment.

Appeals allowed.

Atlantic Sugar Refineries Ltd. v. Minister of National Revenue

(*Exchequer Court of Canada, Thorson P., October 26, 1948*)

Nature of income — Income War Tax Act, R.S.C. 1927, c. 97, sec. 3 — Sugar refinery speculating in sugar futures — Whether profit capital gain — Isolated transaction — Whether trading operation

While Atlantic Sugar Refineries Ltd. had power under its charter to buy and sell raw sugar on the exchange, its ordinary business consisted of purchasing raw sugar by direct purchase from actual holders and selling refined sugar direct to consumers. In the ordinary course of its business it did not sell raw sugar at all. Following the outbreak of war in 1939, there was a heavy increase in the public demand for sugar and at the request of the Government the sugar industry undertook to sell sugar without increase in price, although the cost of raw sugar was steadily rising. Faced with prospective losses because of this situation, the company in September and October, 1939, sold raw sugar futures on the New York sugar exchange and subsequently made equivalent purchases of raw sugar futures, realising a substantial profit on the transactions, which however, it treated as a capital or speculative profit and did not report in its income tax return. Being assessed to tax on such profit, the company appealed.

Held: The profit made on the futures transactions was income within the meaning of section 3 of the *Income War Tax Act*, R.S.C. 1927, c. 97, and the appeal must be dismissed.

WHETHER CAPITAL GAIN

(1) This was not a case of idle capital being temporarily invested in a commodity for a purpose unconnected with the company's business. There was nothing of a capital or investment nature in the transaction. The presence of a speculative element "is not sufficient to determine whether a transaction is of a capital or revenue nature. There are many transactions of a speculative nature that are nevertheless trading or business operations the profits from which are assessable to income tax." [*McKinlay*

v. *H. T. Jenkins & Sons Ltd.* (1926 10 T.C. 372, distinguished; *C.I.R.* v. *Geo. Thompson & Co.* (1927) 12 T.C. 1091; *Imperial Tobacco Co.* v. *Kelly* [1943] 1 A.E.R. 431, considered].

WHETHER A TRADING PROFIT

(2) The fact that the profit was made from what amounted to an isolated transaction of purchase and sale was not decisive against its chargeability. Inasmuch as the purchases and sales of raw sugar were made in consequence of an abnormal emergency which arose in the course of the company's business, and, moreover, were transactions in the same commodity with which it ordinarily dealt, they were of the same character as the company's ordinary trading and business operations, even though they involved a departure from such course; such departure was in the circumstances an operation of the company's business. The profit made might fairly be regarded as "a gain made in an operation of business in carrying out a scheme for profit making," or "a profit made in the operation of the company's business". The operations involved in the transactions were also "of the same kind, and carried on in the same way, as those which are characteristic of ordinary trading in the line of business in which the venture was made." [*C.I.R.* v. *Livingston* (1926) 11 T.C. 538, per Lord Sands at p. 543; *Leeming* v. *Jones* [1930] A.C. 415, *California Copper Syndicate* v. *Harris* (1904) 5 T.C. 159; *T. Beynon & Co.* v. *Ogg* (1918) 7 T.C. 125, applied].

Appeal dismissed.

Orders in Council — Regulations

INCOME WAR TAX ACT — EXCESS PROFITS TAX ACT — REFUNDABLE PORTION OF TAX RETAINED RE UNPAID ARREARS.

P.C. 4640, October 15, 1948

His Excellency the Governor General in Council, on the recommendation of the Minister of National Revenue, is pleased to authorize and doth hereby authorize the Minister of Finance to retain out of any sum or sums of money which may be due or payable, as refundable portion in respect of

(*a*) income taxes for the 1943 and 1944 taxation years or 1943 and 1944 fiscal periods

(*b*) excess profits taxes for the 1943 taxation year or 1943 fiscal period

under sec. 93 of the *Income War Tax Act* (repealed by sec. 18 of Chapter 55 of the Statutes of 1946) or under sec. 18 of the *Excess Profits Tax Act*, 1940, any amount in respect of which the taxpayer is indebted for tax, penalties or interest under either of the aforesaid Acts for any taxation year or fiscal period

(*c*) if the notice of assessment for such taxes has been mailed before the first day of March, nineteen hundred and forty-nine, and

(*d*) if notice of retention is given to the taxpayer.

Provided that such retention shall not affect any subsequent revision of the relevant assessment; and provided further that in the event of an appeal, which in the opinion of the Minister of National Revenue is entered in good faith, the full amount of the refundable portion may be paid to the taxpayer.

A. D. P. Heeney,
Clerk of the Privy Council.

Horrible Consequences of the "New Look"

The following letter to the editor of The Journal of Accountancy is reprinted from the October issue of the Journal·

As an extension of the "New Look" in accounting principles, I suggest the adoption of the reserve system for labor costs. Just as we know that the recovery of old plant cost by cost depreciation is inadequate to provide for replacement at inflationary levels, so we know that recovery of incurred labor costs of today will be inadequate to provide for the fourth-round wage increases tomorrow.

Although some of the best minds in accounting are behind the proposal that in an inflationary market the old idea of buying cheap and selling dear is no longer valid, but should be transmogrified to a theory of dear costs to match dear sales, none of them seems to have pursued the new theory to its logical conclusion. It seems to me that if the low-cost depreciation on a low-cost plant causes its owner to be at an economic disadvantage in comparison with the operator of a high-cost plant, the logical answer ought to be that the low-cost owner should junk his plant and buy a new one at the latest inflated costs. Then he would be at least caught up with his high-cost competitor.

Of course, I can see that raising depreciation by a "book entry" is lots simpler in some ways than buying a whole new plant.

It has been the handling of the offsetting credits for all these new cost charges that has given me pause. But the August *Journal* comforts me, with a report on a dream induced by mixing a heavy meal with some of the American Institute of Accountants' last annual proceedings. If we can just get away from balancing books at all, how simple accounting will be. I am reminded of my industrial client's remarks as we came away from his first session with renegotiation. "If only I didn't have to keep books," he muttered.

As a matter of fact, the theory of regarding the balance-sheet as a display of "residuals," which keeps cropping up in current talk, smacks closely of reducing the double entry system to nothing more than a formalism. If we can charge costs with a figure pulled out of the air or out of a table of statistics, and regard the balance-sheet balance as the "residue," we won't need to care whether or not the balances have any meaning beyond being arithmetically correct differences. What if the inventory and plant accounts turn into "red" balances, or the reserve for the cost of the audit for 1958 mounts to astronomical proportions. Reported net income will be low, because sales will be matched by costs high enough to be what the costs would have been if they had been as high as they should have been to hold the profits down.

If only we can get the Bureau of Internal Revenue to understand how vital the new economics is.

RALPH W. SNYDER, CPA.

The Students' Department

J. E. Smyth, C.A., Editor

Notes and Comments

We have valuable friends who sometimes express ideas that later turn up, innocently enough, in a Students' Department. Some time ago we were talking with one of these friends and among other things he left us with this thought: the main development in accounting during the last decade has lain in the direction of defining the issues we have yet to settle. We gather that in former times accountants just went about their work without asking too many questions—no doubt everything would come out all right in the wash, sooner or later. But now we seem to be in a heart-searching mood. We admit we may not know all the answers but this does not stop us from asking the questions! We are setting up the pins whether we can knock them down or not.

Of course the really big question is now generally recognized as the meaning of income.

To return to our friend, we must say he happened to be in a particularly valuable mood on this occasion. He went on to express what we think is a most realistic approach to this whole problem. He said that there is really no such thing as income in the sense that one definition will do for all circumstances. He said that an all-inclusive definition of income can never be stated satisfactorily. In support of his argument he noted that there is a special way of measuring income for executors, another for municipalities, a definition of income for tax purposes, a different one for the prospective investor, and still another (which eliminates the effects of changes in the value of the dollar) for the economist.

When we thought about it for a moment, his point seemed obvious enough and we wondered if we had not really been aware of it for some time. Perhaps we had. Yet we doubt if it is generally appreciated. We recall, for example, a number of articles by economists who have taken a holier than thou attitude towards accountants just because accountants do not produce the kind of income figure *they* happen to want—when all along the accountants may (or for that matter, may not) have been doing a perfectly satisfactory job for quite another purpose.

Correspondence

Hamilton, Ontario.

Dear Sir,

Having read Mr. Baldwin's letter in the Students' Department on page 159 of the September issue, the right answer to the question, if confined to the determination of the minority interest, I believe has been reached.

However, I think the solution presented is unnecessarily complicated.

Let it be imagined that the subsidiary company is to be wound up. Then the minority shareholders would receive $20,000 of the net assets and 50 shares of the capital stock of the parent company. The parent company would be left with $380,000 (i.e., $300,000 of its own plus $80,000 taken over from the subsidiary). Its capital stock outstanding would be 1,800 shares (i.e., 2,000 shares less the 200 (=250 —50) taken over from the subsidiary). Each share would then have a book value of $380,000/1,800 = $211.11111 each.

Then the minority interest is:—

Net assets (20% of $100,000)	$20,000.00
50 shares in parent company @ $211.11111 each	10,555.56
	$30,555.56

Yours truly,

G. E. F. SMITH.

* * * *

Toronto, Ontario.

Dear Sir:

With regard to the solution, which is contained in the September issue, of Question 2 of the Intermediate Examination, December 1947, Accounting II, I question the method used to distribute the debit balance in A's capital account.

The method illustrated in Smail's and Walker's, *Accounting Principles and Practice*, page 231, states that the deficiency in an insolvent partners' capital account is shared in the ratio of their capital as at the date of dissolution. This would indicate that the correct distribution of "A's" capital would be—

	Capital	*Loss*
B	$220,000	$ 5,567
C	125,000	3,166
D	50,000	1,267
	$395,000	$10,000

and not as shown namely—

	Capital	*Loss*
B	$170,000	$ 5,312
C	112,500	3,516
D	37,500	1,172
	$320,000	$10,000

The method used in the solution is the partners' capital at date of dissolution *adjusted* for the loss on realization of the assets.

I would be glad to hear from you regarding the correct method to use in a case such as this.

Yours very truly,

H. S. HAZLITT.

Editor's Reply

The point seems to be well settled that the deficiency should be distributed in the ratio of the partners' capital balances as at the date of dissolution (as set out in Smails and Walker); the only question here appears to be whether or not the write-down of inventory is a pre-dissolution charge. The solution published is evidently based on the assumption that the write-down in inventory represents an operating charge and that it should be taken into account as having occurred prior to the dissolution. In your solution you are assuming the dissolution to have taken place prior to the sale of the business in which case your treatment is correct. Note however the wording in part (d) of the question: the partnership is to be dissolved *after completion of the foregoing transactions.*

* * * *

Montreal, P.Q.

Dear Sir:

In the course of my examination studies I have discovered the following paradox, which perhaps you or the readers of your department can explain.

Problem: To analyze the change in Sales revenue ($160).

1947—100 articles @ $2 = $200 (qp)
1948—120 articles @ $3 = 360 (QP)

Quantity 1947, 1948 = q, Q
Price 1947, 1948 = p, P
QP — qp = $160
Change in quantity = Q—q = 20 articles
Change in price = P—p = $1

Method I

Change due to quantity increase: 20 x 3	=	$ 60
Change due to price increase: 1 x 100	=	100
		160

Method II

Change due to quantity increase: 20 x 2	=	$ 40
Change due to price increase: 1 x 120	=	120
		160

Question: Which method is correct, and why?

Yours very truly,

(STUDENT'S NAME WITHHELD BY REQUEST)

Editor's Reply

Our view is that the second method is the appropriate one. We think that when one measures the effect of a change in quantity alone, he should keep price changes out of his calculation—and to use $3 is to use a value that includes price changes.

This problem arises also in connection with measuring variances from a budgeted selling price. In that case the change in quantity of goods sold is valued at the budgeted unit price to arrive at the volume variance. We suggest that last year's selling price in your example is analogous to budgeted selling price. In each case the unit figure used to value the quantity change should be unaffected by price caprices over the period for which the variance is measured.

While the volume of sales is different in the two years of your example, the same *type* of article is sold in 1948 as in 1947. Unit for unit the articles sold are the same in each year. In this sense there is nothing inconsistent in associating a 1947 unit price $(2) with the 20 articles representing the change in quantity.

On the other hand there is only one quantity to which the change in price ($1) applies. This is the quantity in fact sold at the increased price (120 articles).

Second Thoughts

(Wherein the editor, having been greatly pleased to receive a number of interesting letters recently, falls quietly off to sleep while reading one of his Students' Departments and dreams he receives yet another letter, this one not so pleasant.)

Dear Sir,

I have now read your October reply to the student who was worried about subscription rights, though goodness knows it took me long enough. If you'll pardon my impertinence, I was rather surprised so much could be said about this particular subject without touching on the main point.

Haven't you heard? A parent company can treat the proceeds of a sale of subscription rights as a profit on one condition. That condition is that the subsidiary will have accumulated profits at least equal to the proceeds of such a sale from the time the parent company acquired part of its stock. If the subsidiary has not built up its undistributed profits since acquisition, then the sale of the subscription rights by the parent company is a reduction of its investment in the subsidiary; it cannot be a way of realizing any increased equity in the subsidiary.

It seems to me that Finney's method of allocation gives one the same superficial satisfaction you get when allocating overhead over departments even when you haven't any logical basis of apportionment.

Yours very truly,

VOX POPULI.

P.S. In the September issue you take "P" and "S" to be the true net worth of the parent and subsidiary companies "respectfully" instead of "respectively". What have you to say to that?

V.P.

Editor's reply (also dreamed): We have nothing to say, but we look guilty.

Problems and Solutions

Solutions presented in this section are prepared by practising members of the several provincial Institutes and represent the personal views and opinions of those members. They are designed not as models for submission to the examiner but rather as such discussion and explanation of the problem as will make its study of benefit to the student. Discussion of solutions presented is cordially invited.

Problem I

INTERMEDIATE EXAMINATION, DECEMBER 1947

Accounting II, Question 5 (20 marks)

For each of the following describe and explain:

(a) the accounting treatment and

(b) the method and extent of disclosure which is desirable in financial statements prepared for presentation to the shareholders of a limited company.

(1) Sale of fixed assets and the resulting profit or loss therefrom.

(2) Substantial recovery on destruction by fire of inventories and fixed assets, the recovery on the fixed assets exceeding the net book value of the relative assets.

(3) Expenses of organizing the company.

(4) Substantial assessment for taxes on income in respect of prior years.

(5) Discount on bonds issued.

(6) Cash deposit in a sinking fund with a trustee under the provisions of a trust deed for a bond issue.

Solution

(1) Sale of fixed assets and the resulting profit or loss therefrom:

(a) The original charge to the asset account together with the relevant depreciation accrued to date of sale should be removed from the fixed asset account and the reserve account respectively, and the amount by which the difference between these two amounts differs from the proceeds of the sale representing the profit or loss on sale should be reflected as a credit or debit in the accounts under the heading of profit or loss on sale of fixed assets.

(b) The net amount of gain or loss on all such transactions during the period under review should be so described and shown separately in the statement of profit and loss under a heading such as subsidiary income or miscellaneous charges. If however the amount is substantial in relation to the earnings of the business, the net gain or loss would frequently be shown as an adjustment in the surplus account.

(2) Substantial recovery on destruction by fire of inventories and fixed assets, the recovery on the fixed assets exceeding the net book value of the relative assets.

(a) The recovery on an account of inventories should be credited to cost of sales or book inventory if such accounts are maintained. In respect of the fixed assets destroyed, the original charge to the asset account together with the relevant depreciation accrued to date of destruction should be removed from the asset account and the reserve account respectively, and the amount by which the recovery exceeds the net book value of the asset should be credited to a separate account for fire loss adjustments in respect of fixed assets.

(b) No disclosure should normally be made of the recovery on account of inventories since in the ordinary course of business the insurance recovery would represent the replacement cost of the goods destroyed. The net recovery on destruction of fixed assets should be shown separately in the statement of profit and loss as "Excess of insurance recoveries over net book value of fixed assets destroyed" under a heading such as miscellaneous income. If however the net recovery is very substantial in relation to the earnings of the business, the net recovery would frequently be shown as an adjustment in the surplus account.

(3) Expenses of organizing the company.

(a) Such expenses should be segregated in a separate account, the usual procedure then being to write them off as a charge to profit and loss over one or more accounting periods. There is however no legal requirement in regard to organization expenses being written off and the auditor cannot take exception to the failure to make any write-offs.

(b) The balance remaining at the end of each accounting period should be shown on the balance sheet of the company as a separate item either at the foot of the assets side or under a heading such as deferred charges. The amount written off during the year should be shown as a separate item in the statement of profit and loss under a heading such as miscellaneous charges.

(4) Substantial assessment for taxes on income in respect of prior years:

(a) The gross amount of the assessments for prior years should be charged to surplus

account and credited to the reserve for taxes on income. The actual payment of the assessment should then be charged to the reserve, thus ensuring that all adjustments affecting taxes on income are passed through the appropriate reserve.

(b) The gross amount of the assessments for prior years should be shown as an adjustment in the surplus account with an appropriate description which may or may not as desired give details as to the years involved and the amounts relative thereto. The liability if not paid at the date of the balance sheet would be included in the reserve for taxes on income with the liability if any for taxes on income for the current year.

(5) Discount on bonds issued.

(a) The amount of the discount should be charged to a separate asset account and should be written off to expense over the life of the bonds either on a "straight line" or a "yield" basis. The discount is not infrequently written off immediately as a charge to surplus but this is not technically correct as the discount represents part of the cost of the funds borrowed and as such should be charged annually against earnings in the same manner as interest on the bonds.

(b) The balance remaining at the end of each accounting period should be shown on the balance sheet of the company as a separate item, either at the foot of the assets side or under a heading such as deferred charges. The amount written off during the year should be shown as a separate item on the profit and loss account under a heading such as miscellaneous charges.

(6) Cash deposited in a sinking fund with a trustee under the provisions of a trust deed for a bond issue.

(a) The cash as deposited should be recorded in a separate account designated as a sinking fund cash account held by the trustee.

(b) The cash so deposited should be shown separately on the balance sheet usually immediately after current assets since it cannot be included in current assets as it is not available for normal purposes of the business. An appropriate description would be "Cash held in sinking fund by trustee."

Editor's Note: Some authorities contend that unamortized discount on bonds is not an asset, and is better shown on the liability side as a deduction from the par value of Bonds payable. (See, for example, Paton, *Advanced Accounting*, page 608.)

Problem 2

FINAL EXAMINATION, DECEMBER 1947

Accounting IV, Question 1 (30 marks)

The partnership agreement existing between A and B expired on 31st December 1946, and A, the senior member of the firm, decided to withdraw altogether in favour of the plant manager C, who for some years had been connected with the firm. B agreed to this, on the understanding that he (B) should assume the senior position and take the larger share of the profits which A up to that time had enjoyed.

The new partnership was organized with an aggregate capital of $600,000 in accordance with the terms of this agreement, and it was agreed further that, for the purpose of the adjustment of the old partners' accounts, the goodwill of the business should be computed as the aggregate of the profits for the last three years, after allowing 5% interest on the capital and after allowing B a salary of $10,000 per annum for having taken the active part in managing the business during this period. A made a private arrangement with C, agreeing to transfer sufficient credit from his account to C to give him (C) the necessary capital for the new partnership. B met his obligations in cash as at 1st January 1947.

It is to be assumed:

(1) That the books of the old partnership are to be continued in use;

(2) That A had a two-thirds interest, and B a one-third interest in the business of the old partnership;

(3) That the net profits for the years 1944 and 1945 as originally arrived at after allowing interest on capital and depreciation on property, and passed to the credit of the partners' accounts were $60,000 and $80,000 respectively;

(4) That interest is to be credited on the capital accounts at the rate of 5% per annum for 1946.

(5) That depreciation should be written off the properties at the rate of 6% per annum for 1946.

A & B TRIAL BALANCE

31st December 1946

Cash	$ 100,000	
Accounts receivable	200,000	
Accounts payable		$ 202,000
Sales		1,000,000
Inventories:		
Raw materials 1st January 1946	195,000	
Operating supplies 1st January 1946	30,000	
Finished goods 1st January 1946	135,000	
Raw material purchases	280,000	
Productive labor	210,000	
Power, heat and light	80,000	
Other manufacturing expenses	12,000	
Supplies purchased	24,000	
Property account	250,000	
A capital		400,000
B capital		200,000
A drawings	24,000	
B drawings	12,000	
Selling expenses	170,000	
General administrative expenses	80,000	
	$1,802,000	$1,802,000

The inventories at 31st December 1946 were as follows:

Raw material	$200,000
Finished goods	150,000
Operating supplies	35,000

The records indicated the following as at 31st December, 1946:

Taxes accrued	$ 5,000
Payrolls accrued	15,000
Insurance prepaid	6,000

REQUIRED:

From the foregoing data, prepare:

(a) Balance sheet of the old partnership as at 31st December 1946, together with a statement of profit and loss for the year ending on that date, as shown by the partnership books.

(b) Journal entries to be made in recording the dissolution of the old firm and the organization of the new one.

(c) The balance sheet of the new partnership at 1st January 1947, after B had met his obligations.

(d) A statement of capital accounts, giving effect to the retirement of A from the firm and the admission of C, and to the change in the status of B.

Solution

STATEMENT 1

A. & B. BALANCE SHEET AS AT 31st DECEMBER 1946.

ASSETS

CURRENT ASSETS			
Cash		$100,000	
Accounts receivable		200,000	
Inventories			
Raw material	$200,000		
Supplies	35,000		
Finished goods	150,000	385,000	
Prepaid Expenses			
Insurance unexpired		6,000	$691,000
FIXED ASSETS			
Property		$250,000	
Less allowance for depreciation		15,000	235,000
			$926,000

LIABILITIES AND CAPITAL

CURRENT LIABILITIES		
Accounts payable	202,000	
Accrued wages	15,000	
Accrued taxes	5,000	$222,000
CAPITAL		
A. Capital	$469,333	
B. Capital	234,667	704,000
		$926,000

STATEMENT 2

A. & B. STATEMENT OF PROFIT AND LOSS

for the Year Ended 31st December, 1946.

Sales		$1,000,000
Less Cost of goods sold		610,000
GROSS PROFIT		$ 390,000
Less Selling expenses	$ 170,000	
General administrative expenses	80,000	250,000
NET PROFIT		$ 140,000

STATEMENT 3

A. & B. STATEMENT SHOWING COST OF GOODS SOLD

for the Year Ended 31st December 1946.

Raw Materials		
Inventory 1st January 1946	$ 195,000	
Purchases	280,000	475,000
Less Inventory 31st December 1946		200,000
		$ 275 000
Direct labor		225,000
Manufacturing expenses		
Power, light and heat	$ 80,000	
Other expenses	6,000	
Supplies	19,000	
Taxes	5,000	
Depreciation	15,000	125,000
Cost of goods manufactured		$ 625,000
Inventory of finished goods 1st January 1946		135,000
		$ 760,000
Less Inventory of finished goods 31st December 1946		150,000
Cost of goods sold		$ 610,000

JOURNAL ENTRIES

A. Capital	$ 20,000	
B. Capital	10,000	
B. Capital		$ 30,000

To record annual salary of $10,000 per year for 1944-5-6.

Goodwill	220,000	
A. Capital		146,667
B. Capital		73,333

To set up goodwill and credit partners in profit-sharing ratio.

A. Capital	200,000	
C. Capital		200,000
In accordance with private arrangement.		

A. Capital	396,000	
A. Loan		396,000
To transfer balance of A. credit to Loan Account.		

Cash	72,000	
B. Capital		72,000
B. meets his obligations in cash.		

CALCULATION OF GOODWILL

31st December 1946

	Profits	B. Salary	Adjusted Profit
1944	$ 60,000	$ 10,000	$ 50,000
1945	80,000	10,000	70,000
1946	110,000	10,000	100,000
			$220,000

B. & C. BALANCE SHEET AT 1st JANUARY 1947

ASSETS

CURRENT ASSETS		
Cash	$ 172,000	
Accounts receivable	200,000	
Inventories	385,000	
Prepaid expenses		
Insurance unexpired	6,000	$ 763,000
FIXED ASSETS		
Property		235,000
GOODWILL		220,000
		$1,218,000

LIABILITIES AND CAPITAL

CURRENT LIABILITIES		
Accounts payable	$ 202,000	
Accrued wages	15,000	
Accrued taxes	5,000	$ 222,000
LIABILITY TO FORMER PARTNER A.		396,000
CAPITAL		
B. Capital	$ 400,000	
C. Capital	200,000	600,000
		$1,218,000

CAPITAL ACCOUNTS

	A.	B.	C.
Investments 1st January 1946	$400,000	$200,000	
Interest on capital	20,000	10,000	
Balance of profit 1946	73,333	36,667	
	$493,333	$246,667	
Less drawings	24,000	12,000	
	$469,333	$234,667	
Salary		30,000	
	$469,333	$264,667	
Salary adjustment	20,000	10,000	
	$449,333	$254,667	
Goodwill	146,667	73,333	
	$596,000	$328,000	
Capital transfer	200,000		$200,000
	$396,000	$328,000	
Transfer to Loan account	396,000		
Cash investment		72,000	
Balances 1st January 1947	—	$400,000	$200,000

Correction to Solution for Final Accounting III, Question 2

(*Students' Department, September 1948, Page 166*)

Montreal, Quebec.

Dear Sir:

On perusing the solution to Accounting III, Question 2 of the December 1947 Final examinations, I have found that the journal entries are a little mixed up and should read as follows:

Entries on A's Books

1. Investment in Company B (not A)
   To Cash
   To record purchase of 1,275 shares @ 160 of Co. B (not A)
2. Investment in Company C (not B)
   To Cash
   To record purchase of 900 shares @ 130 of Co. C (not B)
3. Investment in B (not A)
   To Profit and loss
   To take up 85% of profit of Company B (not A)
4. Cash
   To Investment in B (not A)
   To record receipt of dividend (85% of $20,000)

5. Profit and loss
To Investment in Company C
To take up 90% of loss of Company C
6. Cash
To Investment in C (not B)
To record receipt of dividend (90% of $5,000)

Yours very truly,
L. CORDES.

Editor's reply: We very much regret these errors which must have caused considerable inconvenience to our readers. We would also like to express our thanks to Mr. Cordes for bringing them to our attention.

Audits of Public Boards

The Journal of Accountancy in its October issue reports some confusion which has crept into the affairs of the Texas State Board of Nurse Examiners:

"The State Auditor reports that the last authentic audit was made as at August 31, 1939, by a certified public accountant. 'Audit reports' for intervening years were evidently not prepared by the accountants whose names are on them. Report covers, and in some cases stationery, of certified public accountants had been used to prepare these reports for presentation to the Board. The 'report' for the year ended August 31, 1946, is signed as having been prepared by a certified public accountant who has not been practising in Texas for several years. [There is reason to believe that he was in the Philippines at the time.] Another was in a report cover from an audit report that had been made several years before, and the CPA had died in the interim. The accountant whose report cover was used for the 'report' for the year 1945 stated that he had not made an audit of the Board's records since 1938. The only possible explanation, in the State Auditor's opinion, is that these 'reports' had been made up by the then Secretary-Treasurer who, the State Auditor says, was confined to a state hospital for the insane in July 1947.

"The State Auditor further says, 'All the checks . . . had been drawn by the Secretary-Treasurer and all appear to have been expended for purposes other than Board expense'."

CORRIGENDUM

Tax Directive No. 222 — Depletion — Industrial Mineral Mines

In reproducing the above directive in the November issue, the examples given of industrial minerals occurring in non-bedded deposits were stated erroneously. The paragraph should read:

Examples of industrial minerals occurring in non-bedded deposits are asbestos, feldspar, fluorspar, graphite, mica and nepheline syenite.

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Index to Volume LIII

SUBJECT PAGE

CONTRIBUTORS

Announcing

The Canadian Chartered Accountant

TAX REVIEW

A NEW tax supplement, to be known as *The Canadian Chartered Accountant TAX REVIEW*, will make its first appearance with the January, 1949 issue of *The Canadian Chartered Accountant*. It will be in pamphlet form, of the same dimensions as this magazine, and will be published monthly. A cumulative index will be published in each issue, encompassing all matter contained in previous issues.

Publication of this tax supplement was approved by Council of the Dominion Association of Chartered Accountants at its Annual Meeting in Regina, and comes as a result of two recent innovations in our income tax law, the first being the creation of an Income Tax Appeal Board, which will result in a much larger number of tax cases, and, secondly, the enactment of a new Income Tax Act which provides for the issuance of numerous and involved regulations.

To provide prompt and complete coverage of these matters is a task beyond the scope of the present Tax Department in the magazine. The new *TAX REVIEW* will therefore combine in expanded form the present Tax Department and the Tax Communication Service which has been furnished to members of the Association for the past several years. These will no longer be published.

The supplement will contain all orders in council, regulations, departmental directives, summaries of amendments to the Act and of all tax cases, and in addition, it is hoped, articles and comment on various aspects of taxation law and practice. In this connection contributions from members and readers are solicited.

Arrangements will be made to procure a supply of specially designed binders for filing issues of the TAX REVIEW if there is sufficient demand.

In the JANUARY Issue